Supreme Court, U. S.
FILED
APR 26 1979
MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

October Term, 1978

No. 78-1632

R. M. SMITH, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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CITATIONS.

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The Petitioner, R. M. Smith, Inc., prays that a writ of certiorari issue to review the judgment of this United States Court of Appeals for the Third Circuit entered in the above case on January 26, 1979.

Opinions Below

The original opinion of the Tax Court of the United States, 36 CCH Tax Ct. Mem. 97 (pp. 71-115) is reported and The Supplemental Opinion of the Tax Court (pp. 34-70) is reported, 69 T.C. 317. The opinion of the Court of Appeals for the Third Circuit (pp. 16-33) is reported, 591 F.2d 248.

Jurisdiction

The judgment of the Court of Appeals for the Third Circuit was entered on January 26, 1979 (p. 16). A petition for a rehearing filed on February 8, 1979 was denied on February 23, 1979 (p. 116). The jurisdiction of this Court is involved under 28 U.S.C. 1254(1).

Questions Presented

I. In a Tax Court proceeding where the taxpayer has met his burden of proving the deficiency asserted by the Commissioner is arbitrary and where, during the course of the hearing before the Court, no evidence is introduced concerning the existence of an asset, general good will, nor was its value disclosed as an issue, may the Tax Court make a finding of such an asset's value without affording the taxpayer the opportunity to present evidence?

II. In a Tax Court proceeding when there is an issue raised concerning the fair market value of a deferred installment note made by the taxpayer, which because of the low interest rate, four per cent, has a fair market value of less than the face amount, is the taxpayer as a matter of law precluded from proving its actual value?

Statutes, Federal Rules and Regulations Involved

1. Sec. 334(b)(2), Internal Revenue Code of 1954, 26 U.S.C. 334(b)(2):

> "(2) Exception - If property is received by a corporation in a distribution in complete liquidation of another corporation (within the meaning of section 332(b)), and if—

> (A) the distribution is pursuant to a plan of liquidation adopted not more than 2 years after the date of the transaction described in subparagraph (B) (or, in the case of a series of transactions, the date of the last such transaction); and
>
> (B) stock of the distributing corporation possessing at least 80 percent of the total combined voting power of all classes of stock. . . .
>
> * * *
>
> then the basis of the property in the hands of the distributee shall be the adjusted basis of the stock with respect to which the distribution was made. For purposes of the preceding sentence, under regulations prescribed by the Secretary, proper adjustment in the adjusted basis of any stock shall be made for any distribution made to the distributee with respect to such stock before the adoption of the plan of liquidation, for any money received, for any liabilities assumed or subject to which the property was received and for other items."

2. Sec. 483, Internal Revenue Code of 1954, as amended, 26 U.S.C. 483, in part:

> "SEC. 483. INTEREST ON CERTAIN DEFERRED PAYMENTS.
>
> (a) Amounts Constituting Interest. - For purposes of this title, in the case of any contract for the sale or exchange of property there shall be treated as interest that part of a payment to which this section applies which bears the same ratio to the amount of such payment as the total unstated interest under such contract bears to the total of the payments to which this section applies which are due under such contract.
>
> (b) Total Unstated Interest. - For purposes of this section, the term 'total unstated interest' means, with respect to a contract for the sale or exchange of property, an amount equal to the excess of—

(1) the sum of the payments to which this section applies which are due under the contract, over

(2) the sum of the present values of such payments and the present values of any interest payments due under the contract.

For purposes of paragraph (2), the present value of the payment shall be determined, as of the date of the sale or exchange, by discounting such payment at the rate, and in the manner, provided in regulations prescribed by the Secretary. Such regulations shall provide for discounting on the basis of 6-month brackets and shall provide that the present value of any interest payment due not more than 6 months after the date of the sale or exchange is an amount equal to 100 percent of such payment."

* * *

3. Tres. Regs. § 1.483-1(d)(ii)(A), 26 C.F.R. § 483-1(d)(ii)(A):

"(A) For payments on account of a sale or exchange of property entered into before July 24, 1975, as well as a sale or exchange of property entered into pursuant to a binding written contract (including an irrevocable written option) entered into before such date, the test rate prescribed by this subdivision shall be 4 percent per annum simple interest."

Statement

In this proceeding the Petitioner, "Smith" herein, is contesting income tax deficiencies for the years 1970 and 1971 asserted against it by the Respondent, "Commissioner" herein. The basic facts as reflected in Opinions of the Tax Court are as follows: In January of 1970, Smith acting through its principal, Robert M. Smith, accepted a proposal made to a third party to purchase the operating assets of Gilmour Manufacturing Company, "Gilmour" herein, a small company manufacturing lawn and garden supplies of

$2,000,000 annual sales of predominantly patented products located in Somerset, Pennsylvania. Prior to consummation of the asset sale, R. A. Gilmour, owner of Gilmour's stock, demanded the transaction be changed to a sale of Gilmour's stock and the Petitioner consented; however, the transaction remained essentially the same. R. A. Gilmour retained Gilmour's cash and paid its accounts payable. The purchase price for the stock was increased in the amount $280,550, the market value of nonoperating assets, *i.e.*, real estate, airplane, hanger and construction equipment, which R. A. Gilmour agreed to and did purchase for cash immediately following closing. In addition, R. A. Gilmour agreed to accept as part of the consideration for purchase a second promissory note for $300,000 in lieu of a cash down payment.

Smith acquired control of Gilmour on February 1, 1970 and liquidated the corporation on March 31, 1970. Gilmour assets received in the liquidation were assigned a tax basis of an allocated part of the Smith basis for Gilmour stock pursuant to Sec. 334(b)(2), Internal Revenue Code of 1954, 26 U.S.C. 334(b)(2). Among the assets so received were machinery and equipment and patents. The basis so allocated was utilized by Smith in determining depreciation on its machinery and equipment and amortization of its patents on its 1970 and 1971 income tax returns. The Commissioner redetermined depreciation asserting Smith's basis for these assets were only equal to recapture income and twelve patents developed by Gilmour had no tax basis, one patent of which, the Trigger Grip Nozzle, accounted for 80% of Gilmour's sales.

In the proceeding before the Tax Court, Smith and the Commissioner stipulated to the fair market value of all of the assets Smith received in the liquidation of Gilmour as of March 31, 1970 except certain intangibles. Testimony con-

cerning the value of the patents transferred to Smith was furnished the Court by both parties. The Commissioner did not produce evidence of the value of any other intangibles allegedly transferred. There was no testimony offered by either party in the Tax Court concerning general good will of Gilmour Manufacturing Company on the liquidation date March 31, 1970. Neither did either party offer testimony concerning the value of good will or any asset on the date Smith acquired the stock of Gilmour on February 1, 1970 (pp. 71-115).

The Tax Court held that Smith had met its burden in the Tax Court of establishing that the Commissioner's determination of tax was arbitrary. The Court then proceeded to make its decision without the normal presumptive correctness of the Commissioner's determination (p. 97). The Court continued describing the parties' testimony concerning the value of the patents and an invention as "will-o'-the-wisp" and not acceptable (p. 97). Smith's testimony of its president and appraiser valued the patents and invention at $1,833,392 and $1,997,000, respectively, and the Commissioner's patent attorney valued the same at $434,647 (p. 88). The Tax Court found the value of the patents and an invention to be $860,000 (p. 90). The amount so determined, together with the agreed value of the other asset, left in excess of $1,000,000 in tax basis of the stock to be allocated under Sec. 334(b)(2), *supra.*

Over the Smith objection that general good will was not raised by the Commissioner until after the hearing was closed and the case briefed, and there was no evidence in the record sufficient to make "a specific determination of the fair market value of the trade-mark and goodwill" (p. 110) as required under Sec. 334(b)(2), *supra,* the Tax Court stated that the value of the nondepreciable intangible assets would

be determined under the residuary method of determining value (p. 110). In its Supplemental Opinion, the Tax Court held that Gilmour, this small manufacturing company of $2,000,000 sales of predominately patented products, had nondepreciable intangible assets and good will of $1,225,697.41 (p. 67).

In the Supplemental Opinion, the Tax Court also ruled that the postacquisition, February 1 through March 31, 1970, income taxes of Gilmour would not be added to good will (p. 58) and then, through confusion or inadvertence, added the same to good will (p. 66).

Smith appealed the Tax Court's decision to the Third Circuit questioning, *inter alia,* the determination of good will by the residuary value method, called "residuary value good will".

Residuary value good will is a tax principle utilized for the purpose of determining whether a business has general going-concern value over and above the value of its assets and the amount thereof. The leading case, *Jack Daniel Distillery v. United States,* 379 F.2d 569 (Ct. Cl. 1967), is not a typical example since there was evidence that on an $18,000,000 purchase the parties negotiated and agreed on a figure of $2,500,000 for good will of that company.[1] *Moss American, Inc. v. Commissioner,* 33 CCH Tax Ct. Mem. 1121, is a typical case where the Court dealt with the unknown residuary value good will. Simply stated, it is the mathematical formula which subtracts from the fair market value of the consideration paid for a business, the known fair market value of tangible and intangible assets, to obtain a remainder which is defined as residuary value good will.

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[1] Slightly less than double the alleged good will of Gilmour.

In the Third Circuit, Smith was dealing with the first element of the computation, the fair market value of the consideration paid by Smith for the business, *i.e.*, the stock of Gilmour.

It was agreed that on February 1, 1970, Smith purchased the stock of Gilmour with $780,550 cash; $300,000 7½% three-year promissory note and $2,700,000 4% installment note with no principal payment during the first three years. In addition, Smith assumed certain liabilities, $272,180.92, which accrued on the liquidation of Gilmour Manufacturing Company which were held to be part of the purchase price (p. 30).

Part of the consideration delivered to R. A. Gilmour as of February 1, 1970 for Gilmour stock was an installment note which provided for the payment of four per cent interest and provided for payment of principal beginning three years after February 1, 1970 at the rate of $200,000 per year or 10% of gross sales of Gilmour whichever was greater. Smith asserted the note, which constitutes the bulk of the consideration paid by Smith for the Gilmour stock, must be discounted because of the low interest rate when it is used as the value of consideration paid in computing residuary value good will.

The stature of the proceeding in the Tax Court at the time the determination of residuary value good will was as follows:

(a) The Petitioner had met its burden of proving the Commissioner's determination was arbitrary and the Tax Court was proceeding without the normal presumptive correctness of the Commissioner's determination, *i.e.*, "Commissioner had the burden of proving the proper valuation and thus the actual tax owed." (p. 24)

(b) The issue of residuary value good will was raised by the Commissioner (p. 110).

(c) There was no affirmative evidence supplied the Tax Court concerning the value of good will by either Smith or the Commissioner and both parties limited their evidence to describing and valuing specific property other than general going-concern value transferred by Gilmour to Smith (pp. 71-115).

(d) The Tax Court did not make a determination of the fair market value of the consideration paid by Smith holding:

> "The petitioner's basis as adjusted in the Gilmour Co. stock is the best evidence of the fair market value of the asset acquired."[2] (p. 113)

In this posture, Smith argued before the Circuit that the issue of residuary value good will was raised after the hearing was closed and the case briefed and Smith was denied the opportunity to present evidence of value. Although Smith and the Commissioner disagreed when the issue of residuary value good will was first raised, the Commissioner admitted before the Circuit the issue w is raised in his post-hearing briefs. The Circuit Court, without listening to the Commissioner and without examining the record, ignored the burden of proof and held;

> "Thus, it appears that Smith anticipated the possibility that the Court might find value for goodwill and should have presented evidence on this point at trial." (p. 30)

[2] Smith's adjusted basis for Gilmour stock included an increase over the acquisition basis under Sec. 334(b)(2) by postacquisition earnings and post-acquisition income taxes. Thus, faced with the fact these adjustments would increase good will, the Commissioner could not compute Smith's taxes (p. 35) and one young attorney representing the Commissioner advised the Tax Court that *Moss American, Inc., supra,* could not be applied to this case.

The Petitioner's second point in the Third Circuit was the Tax Court's erroneous presumption that Smith's basis for stock is equivalent to fair market value in computing residuary value good will. This basis included the $2,700,000 deferred payment 4% installment note.

The Circuit Court attacked the discount of the 4% deferred payment installment note on four different and unrelated grounds (p. 30). The grounds and the law relative thereto are:

1. The discount would reduce Smith's basis for Gilmour stock and accordingly not change the Tax Court's computation.

The fact that Smith's promise to pay may be worth less than face does not affect its basis for its stock unless the interest rate comes within the statutory prohibition. Sec. 483 of the Internal Revenue Code of 1954, as amended, 26 U.S.C. 483.

2. The fact that R. A. Gilmour is taxed under the law at capital gain rates on a discount which Circuit Court believes should be ordinary income to him prevents Smith from utilizing the discount factor which should be an ordinary income tax deduction.

One would logically think the opposite of the Third Circuit's inverse reasoning. Since the unstated interest factor is a normal ordinary deduction for Smith, the Court would do everything possible to see that it is deductible and chastise the Commissioner for permitting R. A. Gilmour to utilize the ordinary income factor as a capital gain.

We, of course, do not know if in fact R. A. Gilmour was taxed at capital gain rates or the amount of basis he may have had for his stock. One wonders what the Circuit's position would be if R. A. Gilmour's cost basis in fact exceeded the

selling price and he incurred a loss on the transaction. This is one of the problems when a Circuit attempts to override the provisions of the law with suppositions not appearing of record. Congress has defined unstated interest and provided for tax treatment, Sec. 483, *supra*. The touchstone rate is left to the sound discretion of the Commissioner and he has set the same at 4% for transactions occurring in this period. Tres. Regs. § 1.483-1(d)(ii)(A), 26 C.F.R. § 483-1(d)(ii)(A) (1978).

In today's market with prime interest approaching 12%, the Third Circuit's holding would require practically every installment purchaser to capitalize the real unstated interest as a nondeductible item. This is not the statutory scheme.

3. Admitting the "intuitive appeal" of a discount from face for a 4% note, here actuarially computed to be approximately $700,000, the Court indicates it can find no case law on point.

Again the Circuit failed to take into account the Commissioner had the burden of proof on all questions of fact, and value is a question of fact in the Tax Court. If as the Court states, there are no cases it was required to remand for a factual determination.

4. Finally, citing *Commissioner v. Danielson*, 378 F.2d 771 (C.A. 3, 1967), cert. denied, 389 U.S. 858, 88 S.Ct. 94, the Circuit infers this holding bars a party from proving discount because of submarket interest rate.

The fourth reason stated by the Third Circuit faces the natural law of diminishing returns. If the Tax Court decision cannot be supported by the first and primary legal principle and two subordinate principles, one can expect little support here. This natural law applies since the holding or implied reference conflicts with the Third Circuit's own holding in

Ameranda Hess Corporation v. C.I.R., 517 F.2d 75 (C.A. 3 1975). Since Smith is not seeking to alter the terms of a written agreement, the deferred installment note, the *Danielson case, supra,* has no application here.

Reason for Granting the Writ

I.

The decisions below present this Court with the opportunity to review the procedure rules which stress conclusion of a hearing over determination of the proper amount of tax. The record of the case reflects that the Tax Court did not believe either parties' testimony concerning the value of Gilmour's patent. Classifying the same as "will-o'-the-wisp" (p. 97); however, having no independent expertise in buying or selling patents, the Court proceeded to make a value determination. This value of the patents constituted one of the building blocks for its determination for residuary value good will thus added to the speculative nature of the Court determination of Smith's taxes. Finally, when one is further required to state that a 4% deferred payment installment is worth its face amount, which every homeowner knows is not true, in order to validate the tax, it is a foregone conclusion that such a computation was not even an educated guess.

In the ordinary business world, if an executive has insufficient facts to make a decision, he obtains these facts. The Tax Court, when it knew it could not make an intelligent decision, could reopen the hearing for further testimony or at least offered the parties the opportunity to so present evidence.

Admittedly, the value of the patent was bitterly contested in the Tax Court, as evidenced by Commissioner's Brief and Reply Brief aggregating 150 pages and neither parties expect-

ed the Tax Court holding. However, Smith, and presumably the Commissioner, would produce further evidence necessary to determine the proper tax if offered the opportunity.

II.

The granting of a writ shall give this Court the opportunity to review and define the application of an important case in the tax field, *Commissioner vs. Danielson, supra.* In this case, the Third Circuit adopted a rule of convenience holding a taxpayer cannot attack the normal tax consequences of a contract agreement unless he establishes the common law reason for setting aside the agreement, *i.e.*, fraud, mistake or duress, while not so restricting the Commissioner. Such a rule contravenes the basic principle that substance and not form controls Federal income taxation.

The extent of the application of this case is evidenced by the holding here that the taxpayer cannot prove the value of a four per cent deferred installment note is less than face.

Also the extent of the use of this case is reflected by the fact it has been cited in tax proceedings approximately one hundred times. *Shepard's Federal Citations, 1979 CCH Citator* (listing memorandum decision of Tax Court).

III.

Granting of the writ also shall give this Court the opportunity to advise the Circuit of its duty to apply the law as Congress has enacted it with respect to Smith rather than to legislate based on the capital gains or ordinary income reported by a third party, R. A. Gilmour. This occurred when the Third Circuit held (p. 31):

"If the face value of the note did reflect its market value and the note carried a market rate of interest, then the $700,000 would have been included in interest payments on the note and would have been deductible by Smith. Of course, an equal amount would have to be treated as ordinary income by R. A. Gilmour. By including the sum in the principal portion of the note, the $700,000 becomes a capital gain to Gilmour. The question involving Smith's tax return is whether this amount should be allocated to basis spread among all of the assets received in liquidation allowing Smith to depreciate much of it, or whether it should be assigned to goodwill, a nondepreciable asset. We believe including it in goodwill is the appropriate result in this case."

IV.

Finally, this Court should consider the feasibility of either endorsing Senator Kennedy's bill for special panels in each circuit to handle tax appeals or establishing the same by amending the Circuit Court Rules. Taxes are a specialty in the law, like litigation, S.E.C. proceedings and criminal procedure. This case demonstrates there is a special need for judges with some degree of familiarity with tax law. Such a panel would prevent circuit judges, like Judge Rosen, from going beyond the record and the tax law to reach erroneous conclusions such as (p. 30):

"Smith contends that in determining the price paid, the $2,700,000 note should not have been assigned face value, but that it should have been discounted at its market value, $1,990,943. If this argument is accepted, then the resultant value of the intangible assets would be lower. This would mean that there would be a greater allocation of basis to the depreciable assets, and, thus, greater depreciation deductions. Smith, however, fails to discern the adjustment that then must be made to the $2,700,000 note when calculating the basis in the stock. If the adjustment is made in both places, then the net effect would be nil."

Conclusion

The "incongruous" result (p. 32) holding this small manufacturing company had good will of $1,225,697.41 is an erroneous conclusion as set forth under the above authority and it is respectfully submitted that this Petition for a Writ of Certiorari should be granted.

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APPENDIX

Opinion of the Third Circuit

591 FEDERAL REPORTER, 2d Series

R. M. SMITH, INC., Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE.

No. 78-1442

United States Court of Appeals,
Third Circuit.

Argued Nov. 14, 1978.

Decided Jan. 26, 1979.

Commissioner of Internal Revenue found that taxpayer's amortization deductions were excessive and issued notice of deficiency, and taxpayer sought review. The Tax Court, William M. Drennan, 69 T.C. 317, found that claimed depreciation and amortization deductions were excessive, and taxpayer appealed. The Court of Appeals, Rosenn, Circuit Judge, held that: (1) Tax Court's valuation of depreciable intangible assets was not clearly erroneous; (2) residual value method was appropriate for determining value of goodwill; (3) Tax Court did not err in including difference between face value of note and its asserted market value in goodwill, and (4) while Tax Court erroneously included in total price which taxpayer paid for stock federal income tax liability of acquired corporation for period between acquisition of stock and liquidation of corporation, Tax Court's judgment would not be disturbed since amount of interim earnings erroneously deducted from total price paid exceeded interim income tax liability and more than offset error in including interim tax liability in total price paid.

Affirmed.

1. Internal Revenue—1475

Where taxpayer established that Commissioner's valuation of patent was in error, taxpayer was not required to prove correct figure, but, rather, Commissioner had burden of establishing proper valuation and actual tax owed after proper depreciation deductions were taken.

2. Internal Revenue—1562

Even though taxpayer established that Commissioner's calculation of value of patents was in error and even though Tax Court refused to accept Commissioner's evidence in this regard, where sufficient evidence was introduced to allow Tax Court to reach reasonable conclusion, Tax Court was not limited to simply choosing one of the two valued proffered, but it was appropriate for it to evaluate all of the evidence and to make independent determination that did not necessarily accept valuation of either party.

3. Internal Revenue—1691

Tax Court's finding of fact with respect to valuation of patents for purposes of Internal Revenue Code provisions relating to basis of assets received by corporation in a distribution in complete liquidation of another corporation was to be reviewed under clearly erroneous standard. 26 U.S.C.A. (I.R.C.1954) § 334(b)(2).

4. Internal Revenue—1512

Tax Court's finding of fact with respect to valuation of patents, for purposes of Internal Revenue Code provisions relating to basis of assets received by taxpayer corporation in a distribution in complete liquidation of another corporation, was not clearly erroneous. 26 U.S.C.A. (I.R.C.1954) § 334(b)(2).

5. Internal Revenue—440

Under Internal Revenue Code provisions relating to basis of assets received by corporation in a distribution in complete liquidation of another corporation, before allocation of taxable basis to assets received is made, determination of fair market value of all of the assets must be made. 26 U.S.C.A. (I.R.C.1954) § 334(b)(2).

6. Internal Revenue—440

"Residual value method," which assumes that sum of fair market values of all corporate assets acquired equals price paid for acquisition of these assets, was appropriate for determining value of goodwill for purposes of allocating taxable basis to assets received by taxpayer in a distribution in complete liquidation of another corporation, where there was no proof of substantial variations in asset values during two-month period between acquisition of stock and liquidation of corporation and where taxpayer failed to present evidence showing that price paid was not equal to fair market value. 26 U.S.C.A. (I.R.C.1954) § 334(b)(2).

See publication Words and Phrases for other judicial constructions and definitions.

7. Internal Revenue—440

Under Internal Revenue Code provisions relating to basis of assets received by corporation in a distribution in complete liquidation of another corporation, residual value method, which assumes that sum of fair market values of all corporate assets acquired equals price paid for acquisition of these assets, is an appropriate means for deriving value of intangible assets as long as total price paid and values of all other assets are known; however, resulting figure is not to be

deemed conclusive proof of unknown value, and evidence suggesting that fair deal was not reached should be permitted. 26 U.S.C.A. (I.R.C.1954) § 334(b)(2).

8. Internal Revenue—440

For purposes of Internal Revenue Code provisions relating to basis of assets received by a corporation in a distribution in complete liquidation of another corporation, Tax Court did not err in including in goodwill difference of over $700,000 between face value of 4% promissory note and its asserted market value, which difference resulted from decision by taxpayer and seller corporation to incorporate unstated interest into principal part of installment note, and Tax Court did not err in failing to allocate $700,000 to basis spread among all of the assets received in liquidation. 26 U.S.C.A. (I.R.C.1954) § 334(b)(2).

9. Internal Revenue—1290

When parties themselves have deliberately fixed values to be placed on elements of a transaction, they are bound to accept Commissioner's construction of these values unless they can prove mistake, undue influence, fraud, or duress.

10. Internal Revenue—1701

Although Tax Court erroneously included in total price paid for stock federal income tax liability of acquired corporation for period between acquisition of stock and liquidation of corporation, where Tax Court also erroneously deducted from total price paid interim earnings of acquired corporation, where amount of interim earnings exceeded interim income tax liability and more than offset error in including in total price federal income tax liability, and where Internal Revenue Service did not appeal error in favor of tax-

payer, Tax Court's judgment would not be disturbed. 26 U.S.C.A. (I.R.C.1954) § 334(b)(2).

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Before ROSENN, GARTH and HIGGINBOTHAM, Circuit Judges.

OPINION OF THE COURT

ROSENN, Circuit Judge.

The issues raised on this appeal reflect some of the subtle tax hazards lurking in corporate liquidations. The issues turn on the application of section 334(b)(2) of the Internal Revenue Code of 1954, 26 U.S.C. § 334(b)(2) (1976), dealing with the basis of property received in liquidation of a subsidiary. Section 334(b)(2) provides that "[i]f property is received by a corporation in a distribution in complete liquidation of another corporation," and if certain requirements are met, "then the basis of the property in the hands of the distributee shall be the adjusted basis of the stock with respect to which the distribution was made." Basis in the assets is to be allocated in proportion to the fair market values of the assets. 26 C.F.R. 1.334-1(c)(4)(viii) (1978). In this case, both parties agree that the prerequisites to the applicability of section 334(b)(2) have been met. The dispute hinges on the proper allocation of basis to the property transferred.

I. THE PREDICATE FOR ASSET BASIS

In early 1970, R. A. Gilmour and Robert M. Smith entered into an agreement for the sale of all assets of the Gilmour Company, a manufacturer of lawn and garden equipment, to R. M. Smith, Inc. ("Smith"). At the request of Gilmour, the transaction was changed to a sale of all Gilmour Company stock for a total price of $3,780,550. The agreement did not include identification of the individual values of the assets being transferred. Payment for the stock was as follows: cash in the amount of $780,550; a promissory note for $300,000 at 7 1/2 percent; and an installment note for $2,700,000 at 4 percent. Smith also assumed existing liabilities of Gilmour Company which, by the time of liquidation, totalled $272,180.93. Although the transfer was effective as of February 1, 1970, the transaction was not consummated until March 24, 1970. Within a week, Gilmour Co. was liquidated with Smith retaining the assets. After the liquidation, Smith continued to use the trade names, trademarks, and customer lists of Gilmour Company.

Pursuant to section 334(b)(2) and the underlying Treasury regulations, Smith allocated the refined adjusted basis[1] in the stock to the assets received upon liquidation. Included in this allocation was $1,833,392.53 assigned to depreciable intangible assets, namely six patents and an unpatented invention. No allocation was made to nondepreciable intangible assets (*e.g.*, goodwill) which Smith regarded as having no fair market value. In subsequent tax returns, Smith claimed deductions for the amortization of the patents and invention based on the amount assigned.

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[1] "Refined adjusted basis" is a term adopted by the tax court referring to basis that has gone through two adjustments.

In reviewing Smith's tax return the Internal Revenue Service ("IRS") concluded that only one patent had any basis and that amounted to $10,000. Thus, the Commissioner viewed the amortization deductions as excessive and issued a notice of deficiency. Smith petitioned the tax court for review of this determination.

The primary issue at trial was the fair market value of the patents and the invention.[2] Each side presented an expert witness who employed the identical method of computing the values but used different variables resulting in substantially differing figures of values.[3] The tax court determined that although the identical method employed by the experts was appropriate, each had either overestimated or underestimated certain variables. The tax court fixed the correct valuation at $860,000, a sum between the figures proposed by the witnesses.

The tax court proceeded to find that Smith had failed to assign basis to nondepreciable intangible assets—goodwill, trademark, trade name, and customer lists. The court determined that the value of these intangible assets must be equal to the total purchase price of the stock less the sum of the known values of all other assets. This is based on the assumption that the best evidence of the fair market value of all of the assets is the total price paid for the stock. The court thus determined that the goodwill was worth $1,225,697.41. No attempt was made to fix specific values to the individual components of this total as all are nondepreciable.

[2] Prior to trial the parties agreed to the fair market value of all the tangible assets received by Smith upon liquidation.

[3] The president of Smith, Robert M. Smith, also testified on this issue; however, his testimony was discredited by the trial judge.

The net effect of the court's holdings is that approximately $1.23 million in basis previously assigned to depreciable intangible assets are now assigned to nondepreciable assets, resulting in a reduction in allowable depreciation and amortization deductions.

On appeal, Smith challenges the tax court determinations of the values of the patents and of the nondepreciable intangibles. We affirm.

II. PATENTS AND INVENTION

In support of its assessment of the fair market value of the patents and invention, Smith presented two witnesses qualified to address this issue. Smith's president adopted a method of calculating this figure which the court found "wholly unacceptable" and refused to give weight to the testimony. However, the other witness, a financial appraiser, utilized an approach which the court found appropriate. His analysis yielded an aggregate fair market value for the six patents of $1,867,000.

The Commissioner presented one expert witness, a patent lawyer. The witness employed the same method as Smith's expert, but his gross value for the patents was only $424,647.[4]

The court found that correct valuation of the patents lay in between the two figures presented by the experts. Specifically, it found the royalty rates and projections of future sales used by Smith's expert to be overly optimistic and those variables applied by the IRS expert to be unduly pessimistic. The judge concluded:

[4] The Commissioner abandoned his original position that the total value of these assets was $10,000.

> After giving careful consideration to testimony received, the valuation reports submitted, and the parties' arguments on brief, we have done the best we could to make a reasonable determination of the fair market value of the patents . . ., and, using the same approach used by [both experts], have computed an aggregate amount of $745,000 . . ..

The court also found the unpatented invention to have a value of $115,000. Smith's expert set the figure at $130,000, as opposed to $10,000 by the IRS expert. (The value of this asset is not an issue on appeal.) Thus, the total value of the depreciable intangible assets was determined by the tax court to be $860,000.

[1] Smith's contention on appeal attacks the appropriateness of the tax court assigning this value to the patents. Smith states that it had the burden of proving that the Commissioner's determination of the gross values, which initially amounted to $10,000, was arbitrary. Having established that the calculation was in error, Smith was not required to prove the correct figure. The Commissioner had the burden of establishing the proper valuation and thus the actual tax owed. This much is an accurate statement of the law. *Helvering v. Taylor,* 293 U.S. 507, 55 S.Ct. 106, 79 L.Ed. 623 (1935); *Federal National Bank v. Commissioner of Internal Revenue,* 180 F.2d 494, 497 (10th Cir. 1950).

[2-4] Where Smith's argument fails is in suggesting that the refusal of the tax court to accept the Commissioner's evidence requires this court to reverse the trial judge with instructions to expunge the deficiencies. The teaching of *Helvering v. Taylor, supra,* and *Federal National Bank v. Commissioner of Internal Revenue, supra,* is that the appropriate remedy in the absence of evidence of proper valuation is a remand to allow for additional evidence to be presented. In this case, however, sufficient evidence was introduced to allow the tax court to reach a reasonable conclusion. The court is not limited to simply choosing one of the two values proffered. It is appropriate for it to evaluate all of the evidence and to make an independent determination that does not necessarily accept the valuation of either party. This is not the first time the tax court has used this approach. *See Philadelphia Steel & Iron Corp. v. Commissioner,* 23 T.C.M. 558, 564-65 (1964), *aff'd per curiam,* 344 F.2d 964 (3d Cir. 1965). The court's finding of fact with respect to valuation is to be reviewed under the clearly erroneous standard, *Commissioner of Internal Revenue v. Duberstein,* 363 U.S. 278, 291, 80 S.Ct. 1190, 4 L.Ed.2d 1218 (1960), and in this case must be sustained.

III. NONDEPRECIABLE INTANGIBLE ASSETS

A. *Is the Residual Value Method Appropriate for Determining the Value of Goodwill in this Case?*

[5] According to Treasury Regulation 1.334-1(c)(4)(viii) (1978), the allocation of taxable basis to the assets received in a section 334(b)(2) transaction shall be made in proportion to the fair market value of the assets. Thus, before basis is allocated, a determination of fair market value of *all* of the assets must be made. Having found that Smith received assets not listed on its balance sheet (goodwill, trademark, trade name, and customer lists), the tax court proceeded to assess their worth.

[6] Rather than attempting an independent appraisal of these intangible assets, the court held that their value could be ascertained by the residual valuation method. Simply put, this method assumes that the sum of the fair market values of

all assets acquired equals the price paid for the acquisition of these assets. The formula is the price paid minus known values of assets equals unknown values of the remaining assets. Because the only assets without known values are the nondepreciable intangible assets, this formula can be applied readily to this case and yield the following results:

total consideration paid (price plus liabilities assumed)	$4,052,730.93
less known fair market values of assets (as of date of liquidation)	-2,827,033.52
fair market value of intangible assets	$1,225,697.41

The tax court also found that the evidence justifies allocating this sum to nondepreciable intangibles. Upon liquidation, Smith received an ongoing business that had been profitable for a number of years. It inherited a sound marketing program established in North and South America. It continued to use Gilmour Co.'s trade names which the tax court found were "well and favorably known to the users of lawn and garden equipment and promoted sales of these products."

Smith challenges the appropriateness of the utilization of the residual value method to the facts of this case. Smith presents basically two arguments in support of its contention.

First, Smith points out that two months elapsed between acquisition of the stock and liquidation of the corporation. During this time the value of the assets had to change as a result, for example, of normal appreciation and depreciation. If the value of the tangible assets decreased, then, by applying the residual value method (using total price paid on February 1 and the fair market value of assets on March 31), the assigned value to goodwill would be greater (and vice versa), even though the value of goodwill should remain constant. Although the argument is logically sound, the determination of fair market value, as a practical matter, is not an act of precision but only a matter of approximation. Minor fluctuations in asset values during the two months would be insignificant. Although proof of substantial variations would require adjustments in the resulting goodwill figure, this is not a sufficient reason for altogether abandoning the residual value method. In any event, no such proof was presented in this case.

Appellant's second argument is that the tax court permitted "the Commissioner to introduce as new matter residuary value goodwill after the record was closed" and, as a result, Smith was denied an opportunity to present testimony concerning goodwill. If true, this claim is significant.

As pointed out earlier, the theoretical underpinning of the residual value method is that the total price paid for the stock equals the sum of the fair market values of all of the underlying assets. Although this is a sound principle in economic theory, in reality it has its shortcomings. Specifically, it fails to take into account the common situation when one party to the transaction achieves a bargain. If the purchaser of the stock obtains a "good deal," then the residual value method would undervalue the goodwill. If, on the other hand, the price paid is too high, then the computation will result in a correspondingly inflated goodwill figure. This problem does not require rejection of the residual value method—price paid *is* strongly probative, albeit not conclusive, of fair market value. However, it does suggest that the court consider evidence which would require alterations in the figure or abandonment of the formula altogether.

The cases applying the residual value method recognize this limitation. In *Jack Daniel Distillery v. United States,* 379 F.2d 569, 180 Ct.Cl. 308 (1967), the parties to the sale of stock had agreed to a value for goodwill after actively bargaining in good faith and settling on the value of the other assets. The court rejected an alternative computation for goodwill advocated by the IRS and used the residual method to confirm the figure agreed to by the parties. "The residuary method, though lacking in precision for use in all cases, may in a proper case be accepted as the reasonable way to value goodwill." *Id.* at 579.

In *Moss American, Inc. v. Commissioner,* 33 T.C.M. 1121 (1974), the question was whether the price of the stock was equal to the fair market value of the underlying assets. The IRS argued that the aggregated fair market values exceeded the price by $12.5 million. However, the court concluded that the Commissioner's evidence was insufficient to treat the purchase of stock as a bargain purchase. "If such a purchase had, in fact, occurred, we would, of course, be faced with a different question and respondent's position would have merit." *Id.* at 1127-28.

In *Plantation Patterns, Inc. v. Commissioner,* 29 T.C.M. 817 (1970), *aff'd* 462 F.2d 712 (5th Cir. 1972), and *Philadelphia Steel & Iron Corp. v. Commissioner, supra,* as in the cases above, the court allowed evidence demonstrating the inappropriateness of the residual method to be presented. Only after deciding that the evidence was unpersuasive did the court determine the value of goodwill by this formula. *See also* 10 Mertens, Law of Federal Income Taxation § 59.37 (residual method of valuing goodwill "should be followed with caution and in most cases the value of the goodwill should be supported by other collateral evidence").

[7] The rule to be drawn from these cases is that the residual value method is an appropriate means for deriving the value of intangible assets as long as the total price paid and the values of all other assets are known. The resultant figure, however, is not to be deemed conclusive proof of the unknown value. Evidence suggesting that a fair deal was not reached should be permitted. When appropriate, adjustments should be made in the value assigned to the intangible assets, or a different basis for deriving the figure should be substituted. Collateral evidence supporting a goodwill valuation by the residual method also should be received.

It is evident that in this case the tax court found support for its conclusion that the residual method was appropriate. It considered carefully the evidence which proved that intangible assets of substantial value had been received by Smith upon liquidation. If, however, the court precluded Smith from presenting contrary evidence to show that the price paid was not equal to fair market value, then it committed error. Despite its protestations, our review of the record leads us to the conclusion that Smith did have the opportunity to present such evidence. At trial, Smith argued that any intangible assets received upon liquidation were of nominal value only. The tax court stated in its opinion:

> And, although, petitioner steadfastly maintains that we should sustain its asserted valuation of the patents and invention, petitioner *belatedly* argued that if we should decide that the fair market values of the patents and invention were of lesser amounts than petitioner has claimed, nevertheless, the value of the trademark and goodwill should not be determined under the residual method. Rather, petitioner urges, as best we can understand it, that a specific determination of the fair market

value of the trademark and goodwill must be made . . . (Emphasis supplied.)

Thus, it appears that Smith anticipated the possibility that the court might find value for goodwill and it should have presented evidence on this point at trial.

B. *Did the Tax Court Calculate the Residual Value Goodwill Correctly?*

Smith argues that the tax court erred in the starting point for the residual method—the price paid for the stock. The form of payment for the stock was as follows:

1. $780,550 cash;

2. $300,000 promissory note at 7½ percent for 3 years;

3. $2,700,000 installment note at 4 percent with no principal payments during first three years;

4. $272,180.92 liabilities assumed.

Smith contends that in determining the price paid, the $2,700,000 note should not have been assigned face value, but that it should have been discounted at its market value, $1,990,943. If this argument is accepted, then the resultant value of the intangible assets would be lower. This would mean that there would be a greater allocation of basis to the depreciable assets, and, thus, greater depreciation deductions. Smith, however, fails to discern the adjustment that then must be made to the $2,700,000 note when calculating the basis in the stock. If the adjustment is made in both places, then the net effect would be nil.

It appears that the difference of over $700,000 between the face value of the note and its asserted market value results

from a decision by Smith and Gilmour to incorporate this economic or unstated interest into the principal part of the installment note. If the face value of the note did reflect its market value and the note carried a market rate of interest, then the $700,000 would have been included in interest payments on the note and would have been deductible by Smith. Of course, an equal amount would have to be treated as ordinary income by R. A. Gilmour. By including the sum in the principal portion of the note, the $700,000 becomes a capital gain to Gilmour. The question involving Smith's tax return is whether this amount should be allocated to basis spread among all of the assets received in liquidation allowing Smith to depreciate much of it, or whether it should be assigned to goodwill, a nondepreciable asset. We believe including it in goodwill is the appropriate result in this case.

[8,9] Our independent research has failed to uncover a case which addresses the issue: under the residual method, in calculating the total purchase price for capital stock partially paid by a promissory note, should adjustments be made to the face value of the note when it is apparent from the low interest rate on the obligation that the face value does not equal the market value? The argument in favor of adjustment has intuitive appeal in that greater precision is being used to derive the fair market value of the unknown. However, the effect desired by the taxpayer (increase in bases of depreciable assets) only comes about because less precision is demanded in calculating the basis in the stock. The Internal Revenue Code, 26 U.S.C. § 483 (1976), and the underlying regulations, 26 C.F.R. §§ 483.1-483.2 (1978), require that the treatment of notes for tax purposes be adjusted for unstated interest when the rate assigned is less than four percent.

Because the interest rate of the note in question is four percent, no adjustment is required; nor do we believe one is necessary. We hold that both calculations should be made at face value. *See Commissioner of Internal Revenue v. Danielson*, 378 F.2d 771 (3d Cir. 1967).[5] Thus, the tax court did not err.

[10] The final contention made by Smith is that the tax court erroneously included in the total price paid for the stock the federal income tax liability ($59,766) of the acquired Gilmour Co. for the period between acquisition of the stock and liquidation of the corporation. By application of the residual value method, the increase in the price paid results in an increase in the value assigned to goodwill (see formula, *supra* at 252). As noted earlier, an increase in the amount treated as goodwill results in a lower allocation of basis to depreciable assets. Because the tax court was attempting to derive the value of goodwill as of the date of acquisition, the inclusion of the subsequent tax liability in total price paid is inappropriate. The interim income tax liability in no way would increase the value of goodwill at the time of acquisition.

Reversal is unnecessary, however, because the tax court also erred in deducting from the total price paid the interim

[5] It seems incongruous for the court to approve as large a sum as $1,225,697.41 for the goodwill of a manufacturing concern whose gross revenue only approximates $2,000,000 per annum. This allocation, however, was the direct result of the amount fixed in the installment note by the parties to the sale and purchase. Smith's president was a practicing accountant fully familiar with the affairs of the Gilmour Company, having been its accountant. He should have recognized the possibility that this result might flow from the agreement. When the parties themselves have deliberately fixed the values to be placed on the elements of a transaction, they are bound to accept the Commissioner's construction of these values, unless they can prove mistake, undue influence, fraud, or duress. *Commissioner of Internal Revenue v. Danielson*, 378 F.2d 771, 775 (3d Cir. 1967).

earnings of the Gilmour Co. ($109,700). The interim earnings flowed into the company after acquisition and became part of the value of the assets known (the subtrahend in the residual value formula). Increasing the subtrahend resulted in a reduction of the value assigned to goodwill. The events transpiring during the interim period could not have altered the value of goodwill as of the date of acquisition and again should not have been included in applying the residual value formula. The amount of interim earnings exceeded the interim income tax liability and more than offset the error claimed by the taxpayer. The IRS has not appealed this error in favor of the taxpayer, and thus, the tax court's judgment need not be disturbed.

IV. CONCLUSION

We perceive no reversible error by the tax court and its decision will be affirmed. Costs to be taxed against the appellant.

Supplemental Opinion of the Tax Court

R. M. SMITH, INC., PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 478—74 Filed November 29, 1977.

Following the filing of our opinion in this case, T. C. Memo. 1977—23, the parties submitted conflicting computations of tax under Rule 155. The points of disagreement between the parties, involving for the most part an interpretation of the regulations under sec. 334(b)(2), I.R.C. 1954, have raised various questions which were not presented to the Court in the original proceedings. See n. 17 in our prior opinion. Upon consideration of the parties' arguments, it is

Held:

1. In applying the residual method of valuing intangibles, the known fair market values of the tangible assets are subtracted from the total consideration paid by petitioner for the Gilmour Co. stock, such total consideration to include the cost of the stock plus the liabilities assumed by petitioner plus the Gilmour Co. tax liability under secs. 1245 and 47, I.R.C. 1954.

2. Pursuant to sec. 1.334—1(c)(4)(v)(*a*)(*1*), Income Tax Regs., the addition to tax under sec. 6653(a), I.R.C. 1954, is not an upward adjustment to adjusted basis since it was not a liability assumed as a result of the stock purchase and liquidation.

3. Pursuant to sec. 1.334—1(c)(4)(v)(*a*)(*2*), Income Tax Regs., petitioner's upward adjustment to adjusted basis for interim period earnings and profits is in the amount agreed to by the parties in their initial com-

putations submitted under Rule 155. The initial computations correctly included the effect of the recapture provisions of secs. 1245 and 47, I.R.C. 1954. Further, since the sec. 1245 recapture in this case was not subject to variation during the interim period, the "substituted basis" rules of sec. 1.334—1(c)(4)(vi), Income Tax Regs., are inapplicable herein.

4. Pursuant to sec. 1.334—1(c)(4)(v)(*b*)(*1*), Income Tax Regs., the receivable for prepaid Federal taxes is a cash "equivalent" and therefore a downward adjustment ($58,550) to adjusted basis.

5. Pursuant to sec. 1.334—1(c)(4)(v)(*b*)(*1*), Income Tax Regs., there is an additional downward adjustment to adjusted basis in the amount of $280,550, reflecting additional cash received by petitioner upon the liquidation of Gilmour Co. Prior to the liquidation, Gilmour Co. sold certain real estate, machinery, and equipment to R.A. Gilmour.

6. Pursuant to sec. 1.334—1(c)(4)(v)(*b*), Income Tax Regs., petitioner is not required to offset certain upward adjustments to adjusted basis with matching downward adjustments.

7. Pursuant to sec. 1.334—1(c)(4)(viii), Income Tax Regs., petitioner must subtract the face amount of accounts receivable from the adjusted adjusted basis figure before allocating such basis among the assets acquired by petitioner. On the facts of this case, accounts receivable should not acquire a basis in excess of the $554,767 face amount.

8. Petitioner may not add "globe and pylon" to the stipulated list of assets received by petitioner upon the liquidation. The record does not show that petitioner acquired such asset.

9. The allocation of basis pursuant to the provisions of sec. 1.334—1(c)(4), Income Tax Regs., did not result in a "loss" being incurred in connection with accounts receivable or the various assets sold to R.A. Gilmour.

Kenneth P. Simon, for the petitioner.

Joseph M. Abele, Mike Dennis, and *Michael A. DeLuca,* for the respondent.

SUPPLEMENTAL OPINION

DRENNEN, *Judge:* The opinion in this case (T.C. Memo. 1977—23) was filed on January 31, 1977. In accordance with Rule 155, Tax Court Rules of Practice and Procedure, respondent filed Respondent's Computation for Entry of Decision on April 6, 1977, and petitioner filed Petitioner's Computation of Tax Pursuant to Decision on April 26, 1977. Because the parties differed in their computations, a hearing was held on May 4, 1977, pursuant to Rule 155(b).

Subsequent to that hearing, with the leave of the Court, petitioner filed Petitioner's Memorandum Brief Supporting Rule 155 Computation on May 10, 1977, and respondent filed his Memorandum Brief for Respondent on August 9, 1977. In this memorandum brief, respondent reconsidered the positions he advanced in his previous statements to the Court and made several modifications. In this August 9, 1977, filing, respondent discussed his new positions and revised his computation of tax.[1]

[1] These "modifications" are sufficiently extensive to make the Court wonder what respondent's position will be the next time he addresses these issues.

However, the differences raised in the computations of the parties are not new issues, the raising of which would be precluded by Rule 155(c) of the Tax Court Rules, but arise in applying the opinion of the Court on the issues considered and decided by the Court in its original opinion.

In an order dated August 11, 1977, each party was given until September 12, 1977, to file a response to the opposing party's memorandum brief. Petitioner filed its response on September 7, 1977, in a document entitled Reply Brief of Petitioner Under Rule 155 Computation. Respondent filed his response on September 12, 1977, in a document entitled Reply Memorandum Brief for Respondent.

Petitioner acquired all the stock of Gilmour Co. as of January 31, 1970. On March 31, 1970, it liquidated Gilmour Co. Respondent determined deficiencies in petitioner's own tax liability and in petitioner's liability as a transferee of Gilmour Co.

The basic disagreement between the parties involves the manner in which to compute petitioner's basis in the former Gilmour Co. assets. To make this computation, it is necessary to make some refinements to petitioner's adjusted basis in the Gilmour stock and then to allocate the adjusted basis, so refined, among the acquired assets.[2] This procedure is dictated by section 334(b)(2),[3] which provides, inter alia, that—

> the basis of the property in the hands of the distributee shall be the adjusted basis of the stock with respect to which the distribution was made. For purposes of the preceding sentence, under regulations prescribed by the Secretary, proper adjustment in the adjusted basis of any

[2] In order to avoid the confusion inherent in the terms "adjustments to adjusted basis" and "adjusted adjusted basis," we employ herein the terms "refinements to adjusted basis" and "refined adjusted basis."

[3] All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated. In 1954, Congress enacted sec. 334(b)(2) to effectuate principles derived from *Kimbell-Diamond Milling Co. v. Commissioner,* 14 T.C. 74(1950), affd. per curiam 187 F.2d 718 (5th Cir. 1951), cert. denied 342 U.S. 827 (1951). See S. Rept. 1622, 83d Cong., 2d Sess. 256-257 (1954).

> stock shall be made for any distribution made to the distributee with respect to such stock before the adoption of the plan of liquidation, for any money received, for any liabilities assumed or subject to which the property was received, and for other items.

The parties are not in agreement, first, as to the manner in which to make the refinements to adjusted basis. In this regard, sec. 1.334—1(c)(4)(v), Income Tax Regs., is significant. That section provides:

> (v) The adjusted basis of the subsidiary's stock held by the parent with respect to which the distributions in liquidation are made (reduced as in subdivision (i) of this subparagraph)—
>
> (*a*) Shall be increased— (*1*) By the amount of any unsecured liabilities assumed by the parent, and
>
> (*2*) By the portion of the subsidiary's earnings and profits (less the amount of any distributions therefrom) of the period beginning on the date of purchase and ending upon the date of the last distribution in liquidation attributable to the stock of the subsidiary held by the parent.
>
> (*b*) Shall be decreased:
>
> (*1*) By the amount of any cash and its equivalent received, and
>
> (*2*) By the portion of the subsidiary's deficit in earnings and profits of the period beginning on the date of purchase and ending upon the date of the last distribution in liquidation attributable to the stock of the subsidiary held by the parent.

The parties are also not in agreement as to the manner in which petitioner's adjusted basis in the Gilmour stock (as refined) is to be allocated among the acquired Gilmour assets. In this regard, sec. 1.334—1(c)(4)(viii), Income Tax Regs., provides in pertinent part:

> the amount of the adjusted basis of the stock * * * shall be allocated as basis among the various assets received (except cash and its equivalent) both tangible and intangible (whether or not depreciable or amortizable). Ordinarily, such allocation shall be made in proportion to the net fair market values of such assets on the date received* * *

The specific points which remain in contention between the parties are discussed in the sections which follow.

Calculation of the Value of Intangibles

Under the provisions of section 1.334—1(c)(4)(viii), Income Tax Regs., set forth above, the amount of the parent's refined adjusted basis in the subsidiary's stock is allocated among the various assets received upon liquidation, both tangible and intangible. This allocation is ordinarily made in proportion to the net fair market values of the assets.

Thus, before there can be an allocation of petitioner's refined adjusted basis (in the Gilmour Co. stock it purchased), it is first necessary to ascertain the fair market values of all of the Gilmour Co. assets petitioner acquired.

The fair market values of the tangible assets involved herein either have been stipulated by the parties or have been the subject of findings by the Court. The fair market value of the intangibles is, as stated in our opinion (T.C. Memo. 1977—23), to be calculated pursuant to the residual method of valuation.

In its computation under Rule 155, petitioner arrived at the fair market value of the intangibles by calculating the total amount it paid for the Gilmour Co. Stock ($3,780,550) and by subtracting from that amount the total fair market values of the tangible assets. The amount remaining was, according to petitioner, the fair market value of the intangibles.

In his initial Rule 155 computation, respondent employed a quite different method. However, in his memorandum brief, filed August 9, 1977, respondent's approach is more closely in line with petitioner's. The major difference now between the parties' methods of calculating the value of the intangibles is that respondent increases the $3,780,550 cost figure for the Gilmour Co. stock by adding to it the following amounts:

(1) $159,451.93, reflecting Gilmour Co.'s existing liabilities assumed by petitioner; and

(2) $112,729, reflecting Gilmour Co.'s tax liability under sections 1245 (depreciation recapture) and 47 (investment credit recapture) of the 1954 Code.[4]

Respondent believes it is proper to increase the $3,780,550 cost figure by these two amounts because petitioner knew of these liabilities and must have assumed that the total fair market value of the assets it acquired equaled at least $4,052,730.93 ($3,780,550 plus $159,451.93 and $112,729).

[4] By increasing the $3,780,550 starting figure, respondent obtains a greater value for intangibles and thereby reduces the extent to which refined adjusted basis will be allocated to the tangible (and depreciable) assets. In this regard, it is important not to confuse refined adjusted basis with the cost figure under discussion. The latter figure is essential herein only for the purpose of placing a value on intangibles under the residual valuation method. Once intangibles are assigned a fair market value, the refined adjusted basis (determined in accordance with sec. 1.334—1(c)(4), Income Tax Regs.) is allocated among all assets, tangible and intangible, in proportion to their respective fair market values. Sec. 1.334—1(c)(4)(viii), Income Tax Regs.

We agree with respondent. We believe that the proper application of the residual valuation method requires the use of a cost figure which reflects the total consideration paid. In *Florida Publishing Co. v. Commissioner*, 64 T.C. 269 (1975), affd. without published opinion 552 F.2d 367 (5th Cir. 1977), this Court applied the residual method (see 64 T.C. at 274, 280) and employed as a cost figure "a total consideration of $1,590,956.52 consisting of $1,500,000 in cash and the petitioner's assumption of $90,956.52 in liabilities of the selling corporation." 64 T.C. at 272-273.[5] Among these liabilities were "payroll taxes payable" and "accrued property taxes."

We believe a similar result should obtain on the facts of the instant case. In addition to the purchase price for the Gilmour Co. stock ($3,780,550), petitioner knowingly assumed liabilities of $159,451.93. It is reasonable to conclude that the existence of these liabilities was recognized by petitioner and Gilmour Co. in the course of their negotiations and that the agree-upon stock purchase price took these liabilities into account.

Similarly, there can be little doubt that petitioner was aware of Gilmour Co.'s potential liability under sections 1245 and 47. Robert M. Smith, petitioner's chief executive officer, was a certified public accountant with an extensive tax and accounting practice. As a CPA and tax practitioner, Smith

[5] See also *Moss American Inc. v. Commissioner*, T.C. Memo. 1974—252. While the *Moss American* case does not specifically deal with the residual method for valuing intangibles, it does involve the question of how the fair market values of acquired assets are to be determined in a sec. 334(b)(2) context. There the Court held that the total fair market value of all such assets was, under sec. 334(b)(2), equal to the total of (1) the amount paid by the parent for the subsidiary's stock, plus (2) the amount of the liabilities assumed by the parent.

was cognizant of the depreciation and investment credit recapture provisions of the Internal Revenue Code. He had prepared the returns for Gilmour Co. on which the accelerated depreciation was claimed. In view of these facts, we believe it is a reasonable inference that these potential liabilities were a factor in the bargaining process and had an impact upon the ultimate purchase price for the Gilmour Co. stock.

Respondent was justified, therefore, in adding both of the liabilities in question to the cost of the stock since petitioner must have regarded the acquired assets as having a value at least equal to that total amount. Logically, if we are to place a value on intangibles under the residual method, we must employ a starting figure which represents all of the consideration paid for all of the assets. *Florida Publishing Co. v. Commissioner, supra.*

We conclude that, for the purpose of applying the residual method of valuing intangibles, the known values of the tangible assets are to be subtracted from $4,052,730.93, an amount which reflects the $3,780,550 cost of the stock plus the liabilities assumed ($159,451.93 and $112,729).[6]

[6] Among the assets with known values which respondent subtracts from total consideration (in applying the residual method on his memorandum brief) is a receivable for prepaid estimated Federal taxes in the amount of $58,550. Petitioner's computation does not include this asset, but we believe it properly should be included since it was unquestionably an item of value which petitioner knowingly purchased. This receivable is valued at face amount. See the discussion ahead entitled "Cash and Its Equivalent" at p. 330.

Petitioner has included as one of the subtractions an asset identified as "globe and pylon." That item, valued by petitioner at $9,903.79, is not included by respondent in his list of assets acquired by petitioner. For the reasons given ahead in the section of this opinion entitled "Globe and Pylon," we hold that this item is not to be regarded as an asset acquired by petitioner in the liquidation.

Section 6653(a) Addition to Tax

In our opinion in this case (T.C. Memo. 1977—23), we held that Gilmour Co. was liable for the addition to tax under section 6653(a) because the final corporate tax return for Gilmour Co. failed to include the income realized under section 1245 from the recapture of depreciation previously taken on certain assets.

In their initial computations filed under Rule 155, both parties treated the $5,636.45 addition to tax as an item to be added to adjusted basis under section 1.334—1(c)(4)(v)(*a*)(*1*), Income Tax Regs. Respondent now believes that this amount should not be an upward refinement to adjusted basis.

It is apparent that this liability did not accrue until Gilmour Co. negligently filed its tax return for the period ended March 31, 1970. That return was prepared by Robert M. Smith.

Section 1.334—1(c)(4)(v)(*a*)(*1*) requires adjusted basis to be increased "by the amount of any unsecured liabilities assumed by the parent." This provision of the regulations is directed at arriving at an accurate purchase price for purposes of allocation among the acquired assets. We therefore do not believe that the quoted language can be viewed as encompassing a liability like the addition to tax under discussion, which was not in existence at the time of the stock purchase and liquidation and which arose as a direct result of actions that were taken by the *parent's* chief executive officer well after the close of the subsidiary's final taxable period.

The section 6653(a) addition to tax was plainly not a liability "assumed by the parent" as a result of the stock purchase and liquidation. Under these circumstances, we hold

that the $5,636.45 addition to tax should not be added to adjusted basis.

Interim Period Earnings and Profits

In their original Rule 155 computations, petitioner and respondent agreed that there should be an upward refinement to adjusted basis of $49,934.44 for interim earnings and profits pursuant to section 1.334—1(c)(4)(v)(*a*)(*2*), Income Tax Regs.

The starting point for the $49,934.44 figure was the Gilmour Co.'s taxable income for its taxable year ended March 31, 1970 ($493,650.07). From this amount was subtracted the tax liability of Gilmour Co. ($268,954.08). The resulting figure ($224,704.99) was then divided by 9[7] to obtain an "average monthly earnings and profits" of $24,967.22. This last amount was multiplied by 2, the number of months comprising the interim period, and the result ($49,934.44) was the interim earnings and profits refinement.

Respondent now says that this calculation was incorrect and that only a refinement of $33,961.96 is justified. He points out that his original computation of the E & P refinement included the effect of the recapture provisions of section 1245 and section 47 of the 1954 Code. Respondent contends that the amounts recaptured under these sections upon the liquidation of a subsidiary are "not items which are designed to be included in earnings and profits during the interim period."[8] Respondent argues that gains produced by

[7] This figure was used by both parties in their calculations. We assume Gilmour Co.'s normal fiscal year ended on June 30.

[8] Memorandum Brief for Respondent, filed Aug. 9, 1977, at p. 26.

sections 1245 and 47 are attributable to the period prior to the stock purchase and do not reflect an increase in the value of the subsidiary's stock during the interim period. Therefore, respondent believes no upward refinement to adjusted basis is justified.

We are unable to agree with respondent. We base our conclusion on *First National State Bank of New Jersey v. Commissioner,* 51 T.C. 419 (1968), a case which respondent acknowledges is contrary to the position he advances herein. That case also involved an acquisition and liquidation under section 334(b)(2) and an earnings and profits refinement pursuant to section 1.334—1(c)(4)(v)(*a*)(*2*), Income Tax Regs. The Commissioner had determined that, in its final income tax return, the subsidiary therein had to include in income its reserve for bad debts of $998,325.96. The taxpayer (the parent corporation) argued that, for the purpose of making the refinement to adjustment basis required by the above-cited regulation, this amount should be added to earnings and profits (less the income tax liabilities which resulted to the subsidiary from the addition of this amount to its income). The Court agreed, stating at pages 427—428:

> There was an increase in earnings and profits of [the subsidiary] for its [final taxable] period ending October 10, 1958, because of the additional income it received by adding its bad debt reserve to income. October 10, 1958, was the "date of the last distribution in liquidation" attributable to [the subsidiary's] stock held by [the parent] since the complete liquidation was accomplished on that date. October 10, 1958, was also "the date of purchase" of [the subsidiary's] stock by [the parent]. * * *

it is clear that it was the distribution in liquidation that required the addition to income of the reserve for bad debts since it was upon the liquidation that the bad debt reserve was no longer needed by [the subsidiary]. See *Geyer, Cornell & Newell, Inc.*, 6 T.C. 96 (1946). Therefore, it was an event happening on October 10, 1958, immediately subsequent to [the parent's] acquisition of [the subsidiary's] stock that caused the necessity of adding the $998,325.96 bad debt reserve to * * * income for [the] period January 1 through October 10, 1958. * * * The cause of the increase in income, and therefore the increase in earnings and profits, of [the subsidiary] was the distribution of all of [the subsidiary's] assets in liquidation under an arrangement to which section 334(b)(2) was applicable. This is the situation which respondent's regulations cover. We, therefore, conclude that [the taxpayer/parent] was correct in adding the earnings and profits resulting to [the subsidiary] from the inclusion of the bad debt reserve in its income to the adjusted basis of [the subsidiary's] stock in accordance with respondent's regulations for the purpose of determining its total basis in the assets which it acquired from [the subsidiary] in accordance with the provisions of section 334(b)(2).

In the instant case, as well, the increase in the subsidiary's income (here occasioned by the recapture provisions of sections 1245 and 47) and the resultant increase in earnings and profits was caused by the distribution in liquidation. Thus, as in *First National State Bank of New Jersey*, it was *an event occurring subsequent to the last day of the subsidiary's final taxable period* which necessitated the application of the provisions of sections 1245 and 47 during that taxable period.

Therefore, we conclude that in the present case the recaptured amounts are not to be excluded from the refinement required by section 1.334—1(c)(4)(v)(*a*)(*2*), Income Tax Regs.

Respondent argues alternatively, in the event the Court should hold the *First National State Bank of New Jersey* case to be applicable herein, that it is necessary to apply the "substituted basis" rules of section 1.334—1(c)(4)(vi)(*a*) and section 1.334—1(c)(4)(vi)(*b*), Income Tax Regs., with reference to those assets to which section 1245 applies. Under this alternative argument, respondent calculates an even smaller earnings and profits refinement ($20,355.62).[9]

Section 1.334—1(c)(4)(vi), Income Tax Regs., provides (in pertinent part):

> (vi) For the purpose of subdivision (v)(*a*)(*2*) and (*b*)(*2*) of this subparagraph:
>
> (*a*) With respect to property held on the date of purchase and property held on the date additional stock, if any, is acquired any gain or loss from sales or exchanges of such property (whether tangible or intangible) and any other items determined by reference to basis of such property shall be computed by substituting for such basis a new basis determined by reference to the part of the adjusted basis of the stock allocable to such property.

[9] Respondent arrives at the smaller earnings and profits refinement by subtracting from Gilmour Co.'s taxable income ($493,650.07) the amount of the sec. 1245 recapture ($189,950.16) to arrive at a figure of $303,699.91. He then subtracts the tax on this last amount (ignoring sec. 47) and multiplies the remainder by two-ninths. From the resulting figure ($33,951.96) respondent subtracts the *entire* sec. 47 tax ($13,596.34) since it "would seemingly accrue solely in the two month interim period." The result is a $20,355.62 upward refinement for interim earnings and profits.

> (*b*) The part of the adjusted basis of stock allocable to such property for the purpose of (*a*) of this subdivision shall be the basis of the stock held on the date of purchase or on the date of a later acquisition of stock allocated among the assets held on such date on the basis of their net fair market values on such date,

Respondent asserts that the phrase "any other items determined by reference to basis of such property" encompasses assets to which section 1245 applies.[10]

Respondent apparently believes that the section 1245 recapture is to be ignored completely. He appears to compute the earnings and profits adjustment as though, at the time of the stock purchase, each of the assets had a basis equal to its fair market value. See n. 9 *supra.* By making this assumption, respondent eliminates any requirement to recapture and, correspondingly, eliminates any additional tax liability based on recapture.

We believe respondent's adjustment is not within the intendment of the regulations because it disregards the realities of what actually occurred during the interim period. We have just discussed the necessity of taking the recapture provisions of section 1245 into account in making the earnings and profits adjustment herein, cf. *First National State Bank of New Jersey v. Commissioner, supra,* and respondent's interpretation seems in essence to be directed at circumventing that

[10] Some commentators have conjectured regarding the potential interrelationship of sec. 334(b)(2) and sec. 1245 in this context and have pointed out the complexities that such an interrelationship would create. See, e.g., J. Solari, "Solving Asset Basis Problems Created by 334(b)(2) Liquidations," 29 J. Taxation 150, 151-153 (1968), and J. Sheppard, "Depreciation Recapture: Some Practical Problems in Working with Section 1245," 24 J. Taxation 194, 196-197 (1966).

requirement. We are unable to regard as reasonable a construction of the regulations which suggests that the recapturing of income, a significant event during the interim period, is to be ignored.

We believe respondent has lost sight of the purpose of the regulations on which he relies.

In general, sec. 1.334—1(c)(4), Income Tax Regs., which deals with problems arising when the acquisition of stock and the liquidation do not occur at the same time, is designed "to put the parent in essentially the same position, for basis purposes, as if the subsidiary had been liquidated immediately after the parent purchased its stock." B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders, p. 11—40 (3d ed. 1971). See also *Knapp King-Size Corp. v. United States,* 527 F.2d 1392, 1396 (Ct. Cl. 1975).

To accomplish this purpose, sec. 1.334—1(c)(4)(v), Income Tax Regs., provides that the parent's basis in the subsidiary's stock is to be increased by post-acquisition earnings and profits.[11] In this regard, sec. 1.334—1(c)(4)(vi), Income Tax Regs., utililzes "a hypothetical basis for the subsidiary's assets, determined as if the parent had promptly liquidated [the subsidiary] at the time of the qualifying stock purchase." B. Bittker & J. Eustice, *supra* at 11—41.

[11] See generally the Solari and Sheppard articles cited above in n. 10. In the Sheppard article the following statement appears:

"The net effect of the interim E&P rule is to give Parent the same basis for the assets distributed as it would have had from a prompt liquidation. The intention was to remove any basis advantages or disadvantages from delay. [24 J. Taxation at 196.]"

Cf. *Pacific Transport Co. v. Commissioner,* T.C. Memo. 1970—41, remanded on another issue 483 F.2d 209 (9th Cir. 1973), cert. denied 415 U.S. 948 (1974).

It should be apparent that the recapture provisions of section 1245 would have been applied no differently in this case had the subsidiary been liquidated immediately upon the acquisition of its stock by petitioner. Since the section 1245 recapture in this case is not affected by the delay in liquidation, there is no logical justification for claiming that the application of that section should bring into play the basis rules of section 1.334—1(c)(4)(vi), Income Tax Regs. That provision of the regulations is intended to equalize events which occur during the interim period by having all calculations made with reference to the same point in time—the date of the stock acquisition.

Since the section 1245 recapture in this case was not subject to variation during the interim period, it does not fall within the purview of section 1.334—1(c)(4)(vi).[12]

Accordingly, we conclude that the upward refinement to E & P of $49,934.44, urged by both parties in their initial computations under Rule 155, is to be applied in this case. Aside from the contentions discussed and rejected above, neither party disputes the accuracy of the method by which that figure was calculated.

[12] Similarly, since the provisions of sec. 47 would be applied in the same manner regardless of when the liquidation occurred, that section, too, is not within the scope of sec. 1.334—1(c)(4)(vi), Income Tax Regs. We do not agree with respondent that the entire sec. 47 tax should be applied to the interim period. (see n. 9 *supra.*) A corporation's tax liability for a given taxable year has an effect on earnings and profits during the entire taxable period and should be apportioned accordingly.

Cash and Its Equivalent

(A) *Receivable for Estimated Federal Taxes:*—Section 1.334—1(c)(4)(v)(*b*)(*1*), Income Tax Regs., provides that the adjusted basis of the subsidiary's stock held by the parent shall be decreased by the amount of any "cash and its equivalent" received by the parent. Respondent, in his original Rule 155 computation, determined that petitioner had received $126,114.52 of cash and $58,550 of cash "equivalent" in the form of a receivable for prepaid estimated Federal taxes. Respondent therefore made downward refinements to adjusted basis in those amounts. Petitioner's Rule 155 computation made the same downward refinements to adjusted basis, although petitioner chose to subtract out the $58,550 receivable for estimated Federal taxes by reducing an upward refinement (liabilities assumed) to basis by that amount.

In his memorandum brief, filed August 9, 1977, respondent states that he erred in treating the $58,550 receivable as a cash equivalent. Respondent now believes this item does not satisfy the definition of cash "equivalent" set forth in Rev. Rul. 66—290, 1966—2 C.B. 112. Thus, respondent has eliminated the $58,550 downward refinement to adjusted basis made in his original Rule 155 computation.[13]

In addition to appearing in section 1.334—1(c)(4)(v)(*b*)(*1*), the term "cash and its equivalent" is also found in section 1.334—1(c)(4)(viii), Income Tax Regs., which deals with the

[13] The elimination of a downward refinement to adjusted basis is to the benefit of petitioner because it has the effect of increasing the amounts to be allocated as the bases of its depreciable assets. Nevertheless, because of the complex nature of the regulatory scheme (see, e.g., sec. 1.334—1(c)(4)(viii), Income Tax Regs., which also contains the "cash and its equivalent" concept), we cannot be bound by this concession.

allocation of refined adjusted basis. However, nowhere in the regulations is the term defined.

Some clarification is found in authorities which have employed the "cash and its equivalent" terminology either in a section 334(b)(2) context[14] or in other situations involving the allocation of a lump-sum purchase price among specific assets.[15] See generally 3A J. Mertens, Law of Federal Income Taxation, sec. 21.32, pp. 99—100 (1968 rev.), and the 1977 Annual Cumulative Supplement to Volume 3A, sec. 21.32, pp. 13—14.

An analysis of these authorities indicates that, in order for an item to qualify as a cash "equivalent," it must be in the nature of money; that is, it must be convertible into cash at face amount as a matter of certainty. Where any restrictions or conditions exist on the enjoyment by the taxpayer of the benefits of the full amount, then to the extent of those restrictions or conditions the item does not qualify.

Revenue Ruling 66—290, cited by respondent, is not directly on point.[16] That ruling precludes from the "cash and its

[14] See, e.g., *Boise Cascade Corp. v. United States*, 288 F.Supp. 770 (D. Idaho 1968); Rev. Rul. 66—290, 1966—2 C.B. 112.

[15] See, e.g., *Victor Meat Co. v. Commissioner*, 52 T.C. 929 (1969); *F. & D. Rentals, Inc. v. Commissioner*, 44 T.C. 335 (1965), affd. 365 F.2d 34 (7th Cir. 1966), cert. denied 385 U.S. 1004 (1967). See also *Davis v. Commissioner*, T.C. Memo. 1965—30, and *Graves v. Commissioner*, a Memorandum Opinion of this Court dated May 14, 1952.

[16] Rev. Rul. 66—290, 1966—2 C.B. 112, provides:

"The phrase 'cash and its equivalent' used in sections 1.334—1(c)(4)(v)(b)(1) and 1.334—1(c)(4)(viii) of the regulations includes cash, currency, bank deposits (including time deposits) whether or not interest bearing, share accounts in savings and loan associations, checks (whether or not certified), drafts, money orders, and any other item of similar nature. It does not include accounts receivable (as the term is commonly used), inventories, marketable securities, and other similar current assets."

equivalent" category such items as "accounts receivable (as the term is commonly used), inventories, marketable securities, and other similar current assets." It does not discuss a receivable for prepaid Federal taxes. We would not disagree with the correctness of the ruling as applied to the accounts receivable in the instant case. Since we have no evidence as to the certainty of the collection of these accounts in their face amounts, we would be unable to conclude that they are the "equivalent of money in the bank." *F. & D. Rentals, Inc. v. Commissioner*, 44 T.C. 335, 347 (1965), affd. 365 F.2d 34 (7th Cir. 1966), cert. denied 385 U.S. 1004 (1967). See *Victor Meat Co. v. Commissioner*, 52 T.C. 929, 932 (1969); *Boise Cascade Corp. v. United States*, 288 F. Supp. 770, 772—773 (D. Idaho 1968).

However, we are unable to reach the same conclusion as to the receivable for prepaid estimated Federal taxes. Unlike the situation with regard to the accounts receivable, there can be little doubt here that not a dollar less than $58,550 will be applied to petitioner's benefit. No conditions or restrictions stand in the way of the full amount being so applied. The receivable is therefore like money in a bank account, with its full face value convertible into cash as a certainty for the payment of taxes. As such, it would be illogical for us to include this receivable in these computations among the noncash assets which petitioner acquired in the liquidation.[17]

We hold that the receivable for estimated Federal taxes is an "equivalent" of cash for the purposes of section 1.334—1(c)(4)(*b*)(*1*), Income Tax Regs.

[17] It would be equally as illogical, for purposes of sec. 1.334—1(c)(4)(viii), Income Tax Regs. (which also employs the "cash and its equivalent" terminology), to allot a basis to this receivable which would be in an amount other than $58,550. See the discussion ahead entitled "Allocation of Redefined Adjusted Basis."

(B) *Additional Cash Received:*—In their Rule 155 computations, both respondent and petitioner listed the following items as assets acquired by petitioner upon the liquidation of Gilmour Co.:

Real estate sold to [R.A.] Gilmour	$192,836.10
Machinery and equipment sold to [R.A.] Gilmour	87,713.90

In his memorandum brief, filed August 9, 1977, respondent argues for the first time that petitioner did not acquire these assets; respondent now claims they were sold by Gilmour Co. to R.A. Gilmour on January 31, 1970, for the total amount of $280,550. As a result, respondent concludes that the $280,550 constitutes additional cash received by petitioner under section 1.334—1(c)(4)(v)(*b*)(*1*), necessitating a downward refinement to adjusted basis in that amount.

Some confusion exists in the record because the parties have made inconsistent stipulations. On the one hand, the parties have stipulated that the assets in question were sold by Gilmour Co. prior to the liquidation,[18] and on the other

[18] "5. As a part of the closing of the sale of the stock of Gilmour Manufacturing Company to your petitioner, your petitioner caused Gilmour Manufacturing Company to deed the real estate owned by Gilmour Manufacturing Company to R.A. Gilmour in consideration of the payment by R.A. Gilmour of the book value of the building and landscaping aggregating $192,836.10 and leased back by R.A. Gilmour to your petitioner under the terms and conditions of a lease executed by the parties * * *. The sale price of the building and landscaping in the amount of $192,836.10 was also the fair market value of the building and landscaping of the date of the sale to R.A. Gilmour. [Stipulation of Facts, filed Dec. 4, 1975, at p. 3.]

"6. As a part of the said closing, your petitioner also caused Gilmour Manufacturing Company to sell certain machinery and equipment consisting of an airplane, airplane hanger [sic], bulldozer, etc. and not needed by your petitioner in its business to R.A. Gilmour as follows:

(Footnote continued on following page)

hand, the parties have stipulated that these assets were received by petitioner "upon the liquidation."[19]

We believe the Findings of Fact portion of our original opinion in this case clearly sets forth the timing of the various elements of the sale and liquidation and thereby resolves this conflict:

> The sale [of the Gilmour Co. stock to petitioner] was finally consummated on March 24, 1970, at which time all the stock of Gilmour Co. was transferred to petitioner. Contemporaneously therewith, Smith caused Gilmour Co. to sell its real estate to R.A. Gilmour for $192,836.10, and the airplane hangar and miscellaneous machinery and equipment for [$87,713.90]. R.A. Gilmour then leased the real estate to petitioner for a term of 10 years effective February 1, 1970, at an annual rental of $36,000. * * *

(Footnote continued from preceding page)

Item	*Book value and sales price*
Machinery and equipment	$71,758.57
Airplane hanger [sic]	15,955.33

The sales price[s] of the machinery and equipment and the airplane hanger [sic] in the amounts of $71,758.57 and $15,955.33, respectively, were also the fair market values of said assets, respectively, on the date of the sale to R.A. Gilmour. [Stipulation of Facts, filed Dec. 4, 1975, at pp. 3—4.]"

[19] "10. The parties agree on March 31, 1970 that the fair market value of certain assets received by the petitioner upon the liquidation of Gilmour Mfg. Co., as follows:

Assets	*Value*
* * *	* * *
Real estate described in par. 5 above	$192,836.10
Machinery and equipment and airplane hanger [sic] described in par. 6 above...........	87,713.90

[Stipulation of Facts No. 2, filed Dec. 5, 1975, at p. 2.]"

Between Smith and R.A. Gilmour, the sale and purchase of stock was treated by the parties as if it were consummated on January 31, 1970, as initially contemplated in the memorandum agreement for the sale of assets. * * *

Immediately upon closing of the stock purchase transaction on or about March 24, 1970, petitioner began the liquidation of Gilmour Co., which was completed by March 31, 1970.* * *

It is apparent from our opinion that the sale to R.A. Gilmour took place after petitioner acquired the stock and before petitioner liquidated Gilmour Co. and acquired its assets. We conclude that petitioner did not acquire the assets at issue upon the liquidation and assume it received the cash instead ($192,836.10 plus $87,713.90).

We therefore agree with respondent that the $280,550 constitutes additional cash received by petitioner under section 1.334—1(c)(4)(v)(*b*)(*1*), Income Tax Regs., necessitating a downward refinement to adjusted basis in that amount.

One further point should be mentioned. Because the sales of these items took place during the period following the stock purchase and prior to the liquidation (*i.e.*, during the interim period), it is necessary to determine whether an adjustment is required to earnings and profits for any gain or loss realized on the sales. See in this regard section 1.334—1(c)(4)(vi) and section 1.334—1(c)(5), Income Tax Regs. Neither party discusses this point. On the facts before us, we hold that no such adjustment is required.[20]

[20] For the purpose of applying sec. 1.334—1(c)(4)(vi), Income Tax Regs., we conclude that the "adjusted basis of the stock" (*i.e.*, "the basis of the stock held on the date of purchase") is to be calculated in the same manner

(Footnote continued on following page)

Downward Refinement for Liabilities

In its computation submitted under Rule 155, petitioner included among the downward refinements to adjusted basis required by section 1.334—1(e)(4)(v)(*b*), Income Tax Regs., the following three items:

Liabilities assumed ....[21]	$100,901.93
Recapture taxes ....[22]	112,729.00
Penalty ....[23]	5,636.45

Having also added these items to adjusted basis pursuant to section 1.334—1(c)(4)(v)(*a*)(*1*), Income Tax Regs., petitioner is in effect eliminating these three amounts from the computation of refined adjusted basis.

Labeling the three items "Residuary Value Goodwill," petitioner states that these reductions to adjusted basis,

(Footnote continued from preceding page)

that we computed the cost of the stock in the section of this opinion entitled "Calculation of the Value of Intangibles" at p. 322. The fair market values of all tangible assets have been stipulated by the parties (or determined by the Court), and the fair market value of the intangibles is to be calculated pursuant to the discussion in the above-mentioned section of this opinion. On the facts of this case, "the part of the adjusted basis of the stock allocable to such property" is equal to the fair market value of the property. Since the selling price for the property is also equal to the fair market value, there is no gain or loss to be included as part of the earnings and profits adjustment.

[21] Petitioner arrives at this figure by subtracting from liabilities assumed ($159,451.93) the amount of the receivable for estimated Federal taxes ($58,550).

[22] Petitioner has reference here to taxes arising pursuant to secs. 1245 and 47.

[23] Petitioner has reference here to the addition to tax under sec. 6653(a).

although not to petitioner's advantage, are required by our opinion in this case.[24] Respondent does not agree.

To the extent that we can follow petitioner's reasoning, it appears petitioner is of the view that the Court regards these items as part of goodwill. Since we held in our opinion that goodwill is not to be allocated among the tangible assets received from Gilmour Co., and since the inclusion of these amounts in refined adjusted basis would result in just such an allocation, petitioner believes it must offset its upward refinement (required by sec. 1.334—1(c)(4)(v)(*a*)(*1*)) with a downward refinement.

The flaw in petitioner's thinking is its unwarranted conclusion that the Court treated these amounts as part of goodwill. We did not. We believe the liabilities assumed by petitioner ($159,451.93) and the taxes under sections 1245 and 47 ($112,729) have the effect of increasing petitioner's cost for the stock.[25] They are plainly liabilities which should be added to adjusted basis and then spread among the assets acquired. This is the scheme of the regulations, and we think it is sound. Nothing in the Court's action in denying petitioner's motion for reconsideration and nothing in the pertinent regulatory provisions requires the suggested reductions to adjusted basis. We find no decisional authority or logical justification for it.

We hold that the three items above described should not be subtracted from adjusted basis.

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[24] Petitioner also makes particular reference to the Court's action in denying its Motion for Reconsideration of Findings and Opinion, filed Feb. 24, 1977.

[25] See the discussion of these two amounts in the section of this opinion entitled "Calculation of the Value of Intangibles." As to the $5,636.45 addition to tax under sec. 6653(a), we have concluded that this is an item which is not properly added to adjusted bases. See p. 323 of this opinion.

Allocation of Refined Adjusted Basis

Under section 1.334—1(c)(4), Income Tax Regs., petitioner's refined adjusted basis in the Gilmour Co. stock becomes the total basis for all assets petitioner acquired from Gilmour Co., both tangible and intangible. Allocation of this total figure among the specific assets is accomplished in the manner set forth in section 1.334—1(c)(4)(viii), Income Tax Regs.

An analysis of the language of section 1.334—1(c)(4)(viii) indicates that refined adjusted basis is not to be allocated among items which are "cash and its equivalent." Such items have already been subtracted (at face value) in the course of making the refinements required by section 1.334—1(c)(4)(v)(*b*)(*1*), Income Tax Regs. (See the section of this opinion entitled "Cash and Its Equivalent.") Accordingly, the refined adjusted basis figure does not include a cash element.

Pursuant to section 1.334—1(c)(4)(viii), refined adjusted basis is allocated by spreading that amount among the acquired (non-"cash and its equivalent") assets in proportion to their respective fair market values. Respondent points out that the regulation employs the word "ordinarily" in this context, and respondent argues that accounts receivable ($554,767) is an exception to the "ordinary" situation and should not be allocated a basis in excess of its face amount.[26]

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[26] Because respondent does not regard the receivable for estimated Federal taxes as a cash "equivalent," he makes the same argument with reference to that item. In the section of this opinion entitled "Cash and Its Equivalent," we treated this tax receivable as a cash "equivalent." As such, it cannot be allocated a basis in excess of its face amount ($58,550). The term "cash and its equivalent" must have the same meaning in sec. 1.334—1(c)(4)(viii), Income Tax Regs., that it has in sec. 1.334—1(c)(4)(v)(*b*)(*1*), Income Tax Regs. *Boise Cascade Corp. v. United States*, 288 F.Supp. 770, 772 (D. Idaho 1968).

Respondent believes this item should be subtracted from refined adjusted basis before the allocation is made. Although respondent does not consider this receivable to be "cash and its equivalent,"[27] he feels it would be equally anomalous for it to be subjected to allocation in the "ordinary" manner and thus be assigned a basis which exceeds its face value. (In the instant case, under the general rule set forth in section 1.334—1(c)(4)(viii), Income Tax Regs., accounts receivable would receive a basis in excess of its face amount.)

It is true, as petitioner points out, that both *Boise Cascade Corp. v. United States*, 288 F.Supp. 770 (D. Idaho 1968), and Rev. Rul. 66—290, 1966—2 C.B. 112, adopt the position that this receivable is not to be subtracted under section 1.334—1(c)(4)(v)(*b*)(*2*), Income Tax Regs., in computing refined adjusted basis. But here respondent is arguing that accounts receivable should be subtracted *after* the refined adjusted basis figure is determined. The above-cited authorities do not consider this question or the implications of the word "ordinarily" in section 1.334—1(c)(4)(viii), Income Tax Regs.

There is little doubt in a situation like the present one that respondent has authority to make an "equitable apportionment," (sec. 1.61—6, Income Tax Regs.) "in accordance with the realities of the transaction." *F. & D. Rentals, Inc. v. Commissioner*, 44 T.C. 335, 345 (1965). Further, in a case like the instant one where application of the general rule will result in the allocation of a basis to accounts receivable in excess of its face amount, there can be little doubt that the approach urged by respondent comports more

[27] We agree with respondent that, on the record before us, accounts receivable cannot be regarded as a cash "equivalent." See the discussion above entitled "Cash and Its Equivalent" at p. 329.

with the realities of the situation. Realistically, collection of these accounts could be in an amount *less* than total face amount, but it is highly doubtful that collection could be in *excess* of face amount.

After due consideration, we believe an application of section 1.334—1(c)(4)(viii), Income Tax Regs., which presumes a price higher than face was paid for accounts receivable (by assigning a basis greater than face amount) would be an artifical and overly technical extension of what is only a general interpretive rule. Accordingly, we conclude that, in applying section 1.334—1(c)(4)(viii), Income Tax Regs., the basis ascribed to accounts receivable should be no greater than the total face amount of that asset. On the facts of this case, our conclusion requires that such face amount be subtracted from the refined adjusted basis figure before apportionment is made.

Consistent with the foregoing discussion, the basis of each of the remaining assets is to be determined in accordance with the formula set forth on Schedule Five, *infra*, in the conclusion portion of this opinion. Cf. *F. & D. Rentals, Inc. v. Commissioner*, *supra* at 346.

Globe and Pylon

In the findings of fact portion of our original opinion in this case, based on the stipulation of the parties, we listed the tangible assets of value which petitioner received upon the liquidation of Gilmour Co.

In its Rule 155 computation, petitioner listed an additional asset not included in the stipulation of the parties, an item identified by petitioner as "globe and pylon." The globe and pylon had been subjected by respondent in the statutory

notice to the recapture provisions of section 1245. Petitioner conceded the correctness of this adjustment. Now petitioner claims that the $9,903.79 amount recaptured reflects the fair market value of the globe and pylon at the time of the stock purchase and liquidation. Petitioner contends that this amount was the price at which the globe and pylon, separate and apart from the land on which it was situated, was transferred to petitioner by Gilmour Co. Because respondent applied the section 1245 recapture provisions to this item, petitioner believes respondent is estopped from excluding it as an asset with a value of $9,903.79.[28]

Although petitioner has had ample opportunity prior to these proceedings under Rule 155 to advance the contention that the globe and pylon, as an asset distinct from the land on which it was situated, was a depreciable item received by petitioner in the liquidation at a fair market value of $9,903.79, petitioner has not done so. In fact, petitioner has previously given the Court reason to believe that petitioner had agreed, for purposes of this case, the globe and pylon was to have no value.[29]

While we would ordinarily be inclined to give a petitioner the benefit of the doubt and permit it to include in its computations an asset inadvertently omitted, we are unable to do so when, as here, the factual and legal bases for such in-

[28] Petitioner appears to be arguing that, under the provisions of sec. 1245(a)(1)(B), the $9,903.79 amount at issue reflects either the "recomputed basis" of the globe and pylon or its fair market value, whichever amount is lower. As a result, when respondent determined in his statutory notice that $9,903.79 was to be recaptured under sec. 1245, petitioner believes respondent conceded that the globe and pylon had a fair market value of at least that amount. Had petitioner received the globe and pylon, this argument would not be without merit.

[29] See Brief for Petitioner, filed Mar. 22, 1976, at p. 9.

clusion are not readily apparent. Obviously the burden of proof as to any new assertions is on petitioner, and any omissions in this regard must of necessity inure to petitioner's detriment. Rule 142(a), Tax Court Rules of Practice and Procedure; *Welch v. Helvering*, 290 U.S. 111 (1933). In a proceeding under Rule 155, we are unable to begin an inquiry as to novel factual or legal contentions advanced by either party. Rule 155(c), Tax Court Rules of Practice and Procedure; *Bankers Pocahontas Coal Co. v. Burnet*, 287 U.S. 308 (1932); *Estate of Stein v. Commissioner*, 40 T.C. 275, 278—280 (1963). See generally 9 J. Mertens, Law of Federal Income Taxation, sec. 50.106 (1977 rev.).

In the section of this opinion entitled "Cash and Its Equivalent," at page 330, we discuss the real estate transferred to R.A. Gilmour at a purchase price of $192,836.10. The globe and pylon was included in that transfer.[30]

We point out in our earlier discussion that the sale to R.A. Gilmour took place before petitioner liquidated Gilmour Co. and acquired its assets and that petitioner therefore did not acquire the real estate upon liquidation but received $192,836.10 in cash instead.

Accordingly, on the record before us, we must conclude that petitioner never acquired the globe and pylon. While it is clear from our earlier discussion that the real estate (including the globe and pylon) was leased back to petitioner under a 10-year lease, petitioner has not attempted to establish that the leasehold interest was an asset in which petitioner held a depreciable interest, and the record would not support such a claim.

[30] Petitioner has conceded this point. See Brief for Petitioner, filed Mar. 22, 1976, at p. 9; Petitioner's Computation of Tax Pursuant to Decision, filed Apr. 26, 1977, at p. 1, n. 1; see also transcript of hearing of May 4, 1977, at pp. 4—5.

We hold that petitioner's computation was in error when it included the globe and pylon in the list of acquired assets at a fair market value of $9,903.79.

Losses Claimed by Petitioner

The allocation of refined adjusted basis to the assets acquired by petitioner will, in this case, result in most of the assets being assigned a "new" basis which exceeds the "old" basis they had in the hands of Gilmour Co.

In its Rule 155 computation, petitioner listed four items—inventory, accounts receivable, real estate sold to R.A. Gilmour, and machinery and equipment sold to R.A. Gilmour—and claimed that the difference between the "new" basis (as allocated pursuant to sec. 1.334—1(c)(4), Income Tax Regs.), and the "old" basis (as reported on Gilmour Co.'s final income tax return) in each of these assets was a "loss" deductible by petitioner in the taxable year in which the acquisition occurred (petitioner's taxable year ended August 31, 1970).

(A) *Inventory.*—As to the claimed inventory "LOSS," petitioner points out that an accrual basis taxpayer computes cost of goods sold by subtracting its closing inventory from the sum of (1) opening inventory, plus (2) inventory purchases during the year. If there is an increase in the basis of opening inventory, then, to the extent of the difference, there is a resulting increase in cost of goods sold. According to petitioner, this increase should be deductible.

In his memorandum brief, filed August 9, 1977, respondent agreed "that petitioner is entitled, for its taxable year ended August 31, 1970, to an additional increase in its beginning in-

ventory which would result in a concomitant increase in its cost of goods sold and a similar decrease in its gross profits."[31]

(B) *Accounts Receivable.*—Because of our conclusion herein that the "new" basis in this asset is to be limited to its face amount, there is no increase over the "old" basis ($554,767) and no "loss."

(C) *Real Estate, Machinery, and Equipment Sold to R.A. Gilmour.*—As earlier described, the sale of these items to R.A. Gilmour took place before petitioner liquidated Gilmour Co. and acquired its assets. As a result, in lieu of these items, petitioner received an additional $280,550 in cash upon the liquidation. This amount is subtracted before refined adjusted basis is allocated. It is clear, therefore, that petitioner has no "new" basis with which to compute a "loss."

Conclusion

To avoid further argument and delay in the disposition of this case, we are including below our determination of petitioner's refined adjusted basis in the Gilmour Co. stock and our calculation of the fair market value of the intangibles received in the liquidation. Further, we provide a formula for allocating refined adjusted basis to certain assets acquired by petitioner, and we show the amounts which are to be used in applying that formula. The amounts so allocated to the various assets will be petitioner's basis in those assets for purposes of computing depreciation and amortization. We expect the parties to file with the Court an agreed computation of allowable depreciation and amortization and also a stipulated decision based upon that computation and the findings and conclusions of the Court found herein and in our first opinion in this case.

[31] Memorandum Brief for Respondent at p. 41.

Schedules

The following seven schedules contain our calculations. The fair market value of the intangibles (Schedule Three) is obtained by subtracting the total fair market value of all tangible assets received in liquidation (Schedule Two) from the total consideration paid for the Gilmour Co. stock (Schedule One). We also provide our calculation of refined adjusted basis (Schedule Four) and show the formula (Schedule Five) for allocating that amount (as reduced in Schedule Six) among certain assets (Schedule Seven).

Schedule One: Residual Method: Total Consideration Paid by Petitioner for Gilmour Co. Stock

Purchase price of stock	$3,780,550.00
Plus liabilities assumed under secs. 1245 and 47	112,729.00
Plus other liabilities assumed	159,451.93
Total consideration paid	4,052,730.93

Schedule Two: Residual Method: Total Fair Market Value of All Tangible Assets Received by Petitioner in the Liquidation

Automobile equipment		$ 14,010.00
Dies		15,322.00
Furniture and fixtures		12,552.00
Machinery and equipment		542,865.00
Printing plates		2,065.00
Inventory		360,238.00
Accounts receivables		554,767.00
Receivable for estimated Federal taxes		58,550.00
Patents Nos.:		
D194014	Pistol grip nozzle	355,000.00
3,045,927	Jet speed nozzle	11,000.00
RE 26,013 et al.	Thum Trol nozzle	25,000.00
319,186 et al.	Sprayer	220,000.00
3,207,443	Dual barrel spray head	9,000.00
3,498,543	Wave sprinkler	125,000.00
Invention	Nozzle package	115,000.00
Cash (agreed amount)		126,114.52
Cash (from real estate sold to R.A. Gilmour)		192,836.10
Cash (from machinery, equipment sold to R.A. Gilmour)		87,713.90
Total fair market value of tangible assets		2,827,033.52

Schedule Three: Residual Method: Fair Market Value of Intangibles Received by Petitioner in the Liquidation

Total consideration paid (from schedule one)	$4,052,730.93
Less total fair market value of tangible assets (from schedule two)	2,827,033.52
Fair market value of intangibles	$1,225,697.41

Schedule Four: Calculation of Refined Adjusted Basis

Pursuant to section 1.334—1(c)(4)(v)(*b*), Income Tax Regs., the following refinements are to be made to petitioner's purchase price for the Gilmour Co. stock to arrive at petitioner's refined adjusted basis in the stock:

Purchase of stock	$3,780,550.00

ADD:		
Liabilities		
Liabilities assumed under secs. 1245 and 47	$112,729.00	
Other liabilities assumed	159,451.93	
Earnings and profits		
Interim E and P adjustment	49,934.44	
Total additions		322,115.37
SUBTRACT:		
Cash and its equivalent		
Cash (agreed amount)	126,114.52	
Cash (real estate sold)	192,836.10	
Cash (machinery, equipment sold)	87,713.90	
Receivable for estimated Federal taxes	58,550.00	
Total subtractions		-465,214.52
Refined adjusted basis of stock		3,637,450.85

Schedule Five: Formula for Allocation

Pursuant to section 1.334—1(c)(4)(viii), Income Tax Regs., and the discussion in the section of this opinion entitled "Allocation of Refined Adjusted Basis," the bases of certain assets (see the table on Schedule Seven) are determined in accordance with this formula:

$$X = \frac{A}{B} \times C$$

In the formula, "X" is the basis to be allocated to a given asset (the "unknown"), and "A" is the known fair market value of that asset (as listed on Schedule Seven). "B" is the total fair market value of all assets listed in the table on Schedule

Seven, and "C" is the refined adjusted basis figure after a subtraction, as shown on Schedule Six.

Schedule Six: Calculation of Refined Adjusted Basis Figure To Be Used in Applying Formula

Pursuant to section 1.334—1(c)(4)(viii), Income Tax Regs., and the discussion in the section of this opinion entitled "Allocation of Refined Adjusted Basis," the following subtraction is to be made from refined adjusted basis (as calculated on Schedule Four) before such basis is allocated among the acquired assets:

Refined adjusted basis	$3,637,450.85
Less accounts receivable	554,767.00
Amount to be allocated	3,082,683.85

Schedule Seven: List of Acquired Assets (At Fair Market Value) to Which Formula in Schedule Five Applies

The following table includes all tangible and intangible assets acquired by petitioner in the liquidation (see Schedule Two and Schedule Three), with the exception of (1) items falling in the "cash and its equivalent" category (which are not included in the refined adjusted basis amount; see Schedule Four), and (2) accounts receivable (which is subtracted from refined adjusted basis at face amount, see Schedule Six, and thus, under section 1.334—1(c)(4)(viii), Income Tax Regs., acquires a basis equal to its face amount):

ALLOCABLE ASSETS

Asset		*Fair market value*
Automobile equipment		$ 14,010.00
Dies		15,322.00
Furniture and fixtures		12,552.00
Machinery and equipment		542,865.00
Printing plates		2,065.00
Inventory		360,238.00
Patents Nos.:		
D194014	Pistol grip nozzle	355,000.00
3,045,927	Jet speed nozzle	11,000.00
RE 26,013 et al.	Thum Trol nozzle	25,000.00
319,186 et al.	Sprayer	220,000.00
3,207,443	Dual barrel spray head	9,000.00
3,498,543	Wave sprinkler	125,000.00
Invention	Nozzle package	115,000.00
Intangibles		1,225,697.41
Total fair market value of allocable assets		3,032,749.41

Consistent with the foregoing discussion

An appropriate order will be entered.

Memorandum Opinion of the Tax Court

[CCH Dec. 34,236(M)]

R. M. Smith, Inc., v. Commissioner.

Docket No. 478–74. T. C. Memo. 1977-23. Filed January 31, 1977. [Appealable, barring stipulation to the contrary, to CA-3.—CCH.]

[*Code Secs. 167, 334, 1245 and 6653*]

[Depreciation: Overstated deductions: Valuation of patents and invention: Basis: Additions to tax.] *Held:* Values of patents on various types of lawn and garden equipment and packaging devices determined.

Held, further: Petitioner failed to prove that the failure of petitioner's liquidated subsidiary corporation to report depreciation recapture on its final return was not due to negligence or intentional disregard of rules and regulations. Imposition of addition to tax under sec. 6653(a), I. R. C. 1954, upheld.

Kenneth P. Simon, 747 Union Trust, P. O. Box 2009, Pittsburgh, Pa., for the petitioner. Joseph M. Abele, for the respondent.

Memorandum Findings of Fact and Opinion

DRENNEN, Judge: Respondent determined deficiencies in petitioner's corporate income taxes and a liability against petitioner as a transferee of assets of Gilmour Manufacturing Co. for a deficiency in its corporate income tax and an addition to tax as follows:

	Deficiencies		
TYE Aug. 31,		Corporate income tax deficiencies	Total
1970		$68,123.58	
1971		96,606.94	$164,730.52

	Transferee Liability		
Period	Deficiency	Addition to tax under sec. 6653(a)[1]	Total
July 1, 1969 to March 31, 1970	$124,329.85	$6,216.51	$130,546.36

Due to concessions made by both parties at trial and on brief with regard to both the determined transferee liability and income tax deficiencies, the only issues remaining for decision are:

(1) Whether deductions claimed by petitioner with respect to depreciation and amortization for its taxable years ending August 31, 1970, and August 31, 1971, were overstated because petitioner's basis in depreciable property determined under section 334(b)(2) was overstated.

(2) Whether Gilmour Manufacturing Co., transferor of assets to petitioner, was liable for an addition to tax under section 6653(a) for the period July 1, 1969, to March 31, 1970.[2]

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[1] All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise stated.

[2] Petitioner conceded the deficiency in corporate income tax of Gilmour Manufacturing Co. and that it was liable for the deficiency as transferee.

Findings of Fact

Some of the facts have been stipulated and are found accordingly. The stipulation of facts together with associated exhibits are incorporated herein by this reference.

Petitioner is a corporation organized under the laws of the Commonwealth of Pennsylvania. Its principal office and place of business at the time of filing the petition herein was 926 North Center Street, Somerset, Pa. It filed its Federal income tax returns for its fiscal years ended August 31, 1970, and August 31, 1971, with the Office of the Internal Revenue Service at Philadelphia, Pa.

Prior to the purchase of the stock of Gilmour Manufacturing Co., described below, petitioner was engaged in the business of real estate development. Petitioner filed its income tax returns under the name Morrison Enterprises, Inc., until June 26, 1970, when its name was changed to R. M. Smith, Inc., and its principal place of business was designated as 926 North Center Street, Somerset, Pa.

Gilmour Manufacturing Co. (Gilmour Co. or Gilmour) was also a Pennsylvania corporation with its place of business located in Somerset, Pa. Robert A. Gilmour (R. A. Gilmour) operated Gilmour Co. as a proprietorship from 1948 to 1968, when it was incorporated. Thereafter, R. A. Gilmour was the sole shareholder and president of Gilmour Co., which was engaged in the business of manufacturing lawn and garden supplies including such items as hose nozzles, lawn sprinklers, and sprayers.

Robert M. Smith (Smith) was a certified public accountant maintaining a full-time accounting practice in Johnstown, Pa., prior to December 1970. Smith acquired a controlling interest in the stock of petitioner sometime during 1968 and has

been, since at least that time, the president and chief executive officer of petitioner. In connection with his accounting practice, Smith also served as accountant for R. A. Gilmour as well as Gilmour Co. from 1945 through January 1970.

On January 20, 1970, R. A. Gilmour and Smith, both acting in their capacities as chief executive officers of their respective corporations, entered into a handwritten memorandum agreement for the sale of substantially all of the operating assets of Gilmour Co. and purchase thereof by petitioner on February 1, 1970, for an aggregate purchase price of $3,500,000. A short time subsequent to this agreement, at the insistence of R. A. Gilmour, the agreement for the sale of assets was altered to a sale of stock of Gilmour Co. by R. A. Gilmour to petitioner. The terms of the stock purchase were essentially the same as had been agreed upon in the initial agreement with the following modifications: The purchase price for the Gilmour Co. stock was increased by $280,550 to a total amount of $3,780,550 to cover the value of certain nonoperating assets owned by Gilmour Co. which were not included in the list of assets bargained for. At the closing of the sale, those nonoperating assets owned by Gilmour Co., which had not been included in the original sale of assets agreement, were to be sold by petitioner to R. A. Gilmour for their book and fair market values aggregating $280,550. Those assets were the land and building where Gilmour Co. maintained its offices and plant and which had a book and fair market value of $192,836.10, certain non-operating machinery and equipment valued at $71,758.57, and an airplane hangar valued at $15,955.33. The parties additionally agreed that the above-described building and real estate would be leased back to petitioner for an annual rental of $36,000.

The effective date of the stock purchase transaction was not altered by the above modification, i.e., it remained February 1, 1970. However, after being advised by counsel that the necessary documentation could not be prepared by February 1, 1970, the parties agreed that closing would occur at the convenience of their respective counsel but the transaction would be effective as of February 1, 1970.

The sale was finally consummated on March 24, 1970, at which time all the stock of Gilmour Co. was transferred to petitioner. Contemporaneously therewith, Smith caused Gilmour Co. to sell its real estate to R. A. Gilmour for $192,836.10, and the airplane hangar and miscellaneous machinery and equipment for $86,713.90. R. A. Gilmour then leased the real estate to petitioner for a term of 10 years effective February 1, 1970, at an annual rental of $36,000. The petitioner and R. A. Gilmour also executed an employment agreement hiring the latter as an independent contractor consultant at an annual compensation of $25,000 for a period of 5 years effective as of February 1, 1970.

Between Smith and R. A. Gilmour, the sale and purchase of stock was treated by the parties as if it were consummated on January 31, 1970, as initially contemplated in the memorandum agreement for the sale of assets. R. A. Gilmour's salary as president of Gilmour Co. ceased as an officer on January 31, 1970, and he was thereafter paid by petitioner a lesser amount pursuant to the above-described consulting agreement dated March 24, 1970. Petitioner paid R. A. Gilmour rent for the real estate occupied by the business pursuant to a lease dated March 24, 1970, and made effective February 1, 1970, in the amount of $3,000 each for the months of February and March 1970. R. A. Gilmour maintained control of Gilmour Co.'s bank account and paid all liabilities ac-

crued as of February 1, 1970. Smith opened a new bank account into which all receipts of Gilmour Co. were deposited after January 31, 1970.

Immediately upon closing of the stock purchase transaction on or about March 24, 1970, petitioner began the liquidation of Gilmour Co., which was completed by March 31, 1970. The fair market values and, where pertinent herein, the useful lives of the tangible assets received by petitioner upon liquidation of Gilmour Co. have been stipulated as follows:

Assets	Value	Useful life
Automobile equipment	$ 14,010.00	5 years S/L
Dies	15,322.00	7 years S/L
Furniture & fixtures	12,552.00	6 years S/L
Machinery & equipment	542,865.00	10 years S/L
Printing plates	2,065.00	4 years S/L
Inventory	360,238.00	
Accounts receivable	554,767.00	
(Total)		($1,501,819.00)
Real estate sold to Gilmour	192,836.10	
Machinery & equipment and airplane hangar	87,713.90	
(Total)		($280,550.00)
(Total)		($1,782,369.00)

On liquidation of Gilmour Co., petitioner also received cash of $126,114.52 and a receivable of $58,550 for 1969 estimated Federal tax payments. Petitioner assumed liabilities of Gilmour Co. in the amount of $159,451.93.

The remaining assets which petitioner received upon liquidation of Gilmour Co. were intangible assets and in-

cluded[3] a number of patents for hose nozzles, spraying devices, and sprinklers, an invention for packing nozzles for sale, a trademark (Hosemaster), and the right to use the Gilmour name.[4]

On its tax returns for the years at issue petitioner claimed deductions for amortization with respect to the patents and invention based upon an aggregate amount of basis for said assets of $1,833,392.53. Respondent, in notices of deficiency for the taxable years at issue herein, determined that only one patent had an amortizable basis and that the amount thereof was $10,000; respondent assigned no value to, recognized no tax basis in, and allowed no amortization for the remaining patents or the invention.[5]

[3] The question as to whether petitioner received goodwill from Gilmour Co. upon its liquidation is discussed *infra*. It should be noted, however, that petitioner has taken the position on its returns, at trial, and on brief that it received no goodwill from Gilmour Co.

[4] The total cost for the intangible assets reflected on Gilmour Co.'s books was $10,000 which it had paid for a patent.

[5] Respondent, since trial, has taken the position that the aggregate value of the patents and invention for purposes of amortization is no more than $434,647. See discussion *infra*. Respondent's theory is that the excess of the purchase price of the stock over the stipulated values of the tangible assets and the values he allocates to the patents received by petitioner on liquidation of Gilmour Co. should be allocated to "residual goodwill." Petitioner takes the position that the excess of the purchase price of the stock over the stipulated value of the tangible assets should be allocated to the patents or other depreciable assets, that the trademark and Gilmour name had no value, and that the Gilmour Co. had no goodwill of value to petitioner.

The depreciation and amortization deductions claimed by petitioner on its returns and the amounts allowed by respondent with respect to the fiscal years involved herein, are as follows:

	Fiscal year ended August 31, 1970		Fiscal year ended August 31, 1971	
	Claimed	Allowed	Claimed	Allowed
Depreciation — automotive equipment, machinery and equipment, dies, molds, furniture and fixtures, printing plates, Hosemaster globe and pylon	$32,116.66	$19,291.15	$ 78,298.68	$45,700.53
Amortization of patents	65,797.30	245.10	157,913.52	588.23
Totals	$97,913.96	$19,536.25	$236,212.20	$46,288.76
Less: Depreciation and Amortization allowed	19,536.25		46,288.76	
Adjustment (amounts disallowed) ..	$78,377.71		$189,923.44	

The various patents and invention with which we are concerned herein and the products with which they are associated are as follows:

	U. S. Patent Number	Associated Product
1	D 194,014	Pistol-grip nozzle
2	3,045,927	Jet Speed nozzle
3	RE 26,013, et al.	Thum Trol nozzle
4	3,191,869, et al.	Sprayer
5	3,207,443	Dual barrel spray head
6	3,498,543	Wave sprinkler
	Invention	Nozzle package

A brief description of the products covered by the above patents, in layman's language, is as follows:

Patent No. 1 (D 194,014)—Pistol-grip nozzle.—This patent protects the design of a pistol-grip hose nozzle manufactured by Gilmour Co., the distinctive features of which include a flared handle and easy-to-grip control.

Patents No. 2 (3,045,927 et als.)—Jet speed nozzle.—This patent was a mechanical patent protecting the manufacture of a rotary-type nozzle. The distinctive characteristic of this nozzle is that it can be completely opened or closed, so as to control the pattern of water spray, by turning the barrel of the nozzle only one-half turn, *i.e.,* 180 degrees.

Patents No. 3 (RE 26,013 et als.)—Thum-Trol Nozzle.—These mechanical patents protect the manufacture of a barrel-type nozzle which controls the flow of water by a thumb activator, *i.e.,* a slide which looks and operates very much like a slide found on a flashlight.

Patents No. 4 (3,191,869 et als.)—Sprayer.—These patents deal with the spray-head mechanism of spraying devices used primarily in dispensing fertilizers, insecticides, weed killers, or disinfectants. The device controls the amount of the liquid fertilizer or insecticide held in a plastic container attached to the sprayer which is drawn from the container through a plastic tube into the spray head and dispensed therefrom together with the water flowing from the attached hose.

Patent No. 5 (3,207,443)—Dual-Barrel Spray Head.—The product manufactured under this patent is advertised as a dual-barrel acid-cleaning gun. This device is similar to the sprayer covered by Patent No. 4 except that it has two conduit barrels and two separate spray heads which permits cleaning an aluminum trailer, for instance, with a mixture of the

secondary liquid (acid) and water, and then by adjusting the controls, rinsing it off with water alone.

Patent No. 6 (3,498,543)—Wave Sprinkler.—The product manufactured under this patent is an oscillating or wave-type lawn sprinkler. But instead of a rigid bar spray head, this device has a flexible tubular bar head which permits adjustment of both the length and width of the water pattern.

Invention—Nozzle package.—This invention, which was not patented at the time of the liquidation of Gilmour Co., provided a method of affixing a nozzle (or similar device) to a display card by means of a plastic button rivet driven through a hole in the nozzle handle and through a hole in the card. This permits a potential purchaser to remove the nozzle from the card to examine it and return it to the card without damage to the card. The more conventional methods of affixing the product to the card by means of tape, wire fasteners, or a plastic covering do not possess this feature.

In attempts to establish the proper fair market values for the above-described intangible assets, petitioner presented the testimony of its president, R. M. Smith, and, as its expert witness, Murray V. Johnston; respondent presented the testimony of one expert witness, James P. Burns, Esq.

R. M. Smith has had no experience in valuing patents of any type. Smith had no experience in the business of manufacturing or selling nozzles, lawn sprinklers, or sprayers prior to petitioner's acquisition of Gilmour Co., except in connection with his rendering of accounting services to Gilmour Co., R. A. Gilmour, and A. W. Francis Co. (another manufacturer of lawn and garden supplies). Smith has never testified in any proceeding as an expert on the valuation of patents.

In December of 1970, in order to allocate the amount of petitioner's adjusted basis in its Gilmour Co. stock to the assets received from the liquidation of Gilmour Co. for the purpose of establishing the respective bases of said assets pursuant to section 334(b)(2), R. M. Smith prepared a schedule of the patents and invention owned by Gilmour Co. on February 1, 1970. On this schedule Smith recorded what he determined to be the fair market values of said patents and invention as of February 1, 1970; the aggregate amount of these values was $2,542,505. However, Smith determined that the available amount of petitioner's adjusted basis[6] in its Gilmour Co. stock, after determining the fair market values of the tangible assets petitioner received on liquidation and allocating a corresponding amount of the adjusted basis to said assets, was less than the amount he had determined constituted the fair market values of the patents and invention. As a result Smith reduced pro rata the amounts allocated to the patents and invention to an aggregate amount of $1,833,392.53. These reduced amounts shown as "value allocated" on the schedule reproduced in the margin,[7] were recorded on petitioner's books and records and used by petitioner as bases for purposes of computing deductions claimed for amortization on its returns for the years at issue.

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[6] Under sec. 334(b)(2) and the pertinent regulations the total combined amount of a parent's basis in all of the assets received from the subsidiary in liquidation is the parent's adjusted basis, as further adjusted, in the stock of the subsidiary.

[7] (Footnote 7 appears on next page).

GILMOUR MANUFACTURING COMPANY
PATENTS
January 31, 1970

Patent #	Description	Period Issue	Period Expires	Catalog #	Value Per Unit	Est. Sales Per Year	Value Per Year	Remaining Life Yrs.	Total $ Value	$ Value Allocated
1. Des 194,014	Hose nozzle	11-6-62	11-6-78	562,563 all nozzles for sprayers	.01-½	2000M	30,000	6-8/12	202,500	145,000.00
2. 3,045,927	Spray nozzle	7-24-62	7-24-79	320	.01	35000	350	9-4/12	3,325	3,000.00
Des 189,411	Spray nozzle	12-6-60	12-6-74	320	.005	35000	175	4-8/12	846	392.53
666,308 (Canadian)	Spray nozzle (jet speed nozzle)	7-9-63	7-9-83	See # 3,045,927 above	......	......	......	......	......	......
3. RE 26,013	Hose nozzle (thum trol)	1-8-63	1-8-80	TT 65	.25	50M	10,000	9-9/12	123,959	90,000.00
Des 202,686	Hose nozzle (thum trol)	10-26-65	10-26-79	TT 65	......	......	......	......	......	......
4. 3,191,869 (2,754,152 also protects #362)	Spraying device having restricted orifice & expansion chamber construction	6-29-65	6-29-82	362	1.25	50M	62,500	12-3/12	776,042	560,000.00
3,112,884	Spraying device	12-3-63	12-3-80	not being mfg'd	......	......	......	......	......	......
3,090,564 2,788,245* 2,788,244*	Spraying device with dilution control	5-21-63	5-21-80	484 protected by this patent	1.25	50M	62,500	10-4/12	645,833	465,000.00
5. 3,207,443	Dual spray head having vent control means	9-21-65	9-21-82	62,628 628H	1.50	4M	4,500	12-8/12	76,000	55,000.00
6. 3,498,543	Wave sprinkler	3-3-70	3-3-87	3000 plus others later	2.00	15M	30,000	16-11/12	510,000	365,000.00
Invention	Carded nozzle packaging (Machine)	none	none	all nozzles	.006	2000M	12,000	17	204,000	150,000.00
Total							212,025		2,542,505	1,833,392.53

In making his determination of the fair market values of the patents and the invention Smith took into consideration the nature of the patent, the selling price of the related manufactured item, and the value to petitioner as he saw it at that time. The technique used by Smith in determining the contested values of most of the items was essentially as follows: Smith first determined what he characterized as a patent's "value per unit" manufactured. He computed this value in most cases by comparing the net selling price of the item manufactured under the particular patent with the net selling price received from the sale of a different model of the same or a similar type item. For instance, patent No. 6 (3,498,543) pertained to "wave sprinkler". Model No. 3,000 had a net selling price of $7.28. Gilmour Co. also manufactured and sold another wave sprinkler, Model No. 2,800 (apparently not protected by patent) for a net selling price of $5.25. The difference in the net selling prices received for these items is approximately $2.00; Smith determined that this amount was the unit value of products manufactured under patent No. 6. However, different methods were used in at least two instances: Smith determined a unit value for patent No. 1 of $.015 by talking to petitioner's employees and estimating a value per unit to petitioner. In determining a value for the invention owned by Gilmour Co., Smith calculated a unit value of $.006 based upon savings of labor cost per item sold resulting from the use of the card packaging invention.

After determining a unit value for the particular patent under valuation, Smith multiplied this unit value by the estimated annual sales of the item manufactured to compute an amount characterized as "value per year." Smith estimated the sales for each product manufactured under patent based

upon his general knowledge of Gilmour Co.'s sales history[8] and upon information gathered from his discussions with, presumably, key employees about their predictions as to future sales.

Smith's computations were then completed by multiplying the "value per year" by the number of years the particular patent would continue legally enforceable.[9]

Petitioner called Murray V. Johnston to testify as an expert witness with regard to the valuation of the patents and invention. Johnston is a self-employed financial consultant and financial appraiser. He began offering consulting services in 1961 and was certified as a member of the American Society of Appraisers in 1963 and offered appraisal services thereafter. During the vast majority of Johnston's professional career, from 1928 until 1961, he was an employee of Gulf Oil Corp. During the last 6 years of his association with Gulf he was employed as general credit manager. During Johnston's employment with Gulf he had experience in determining values of intangible assets; this was in connection with appraisals of various businesses that Gulf, at one time or another, was considering acquiring. However, this experience was limited in scope to determining the value of goodwill.

[8] There is no evidence refining or explaining what is included in the vague notion of Gilmour Co.'s "sales history." It appears that records of actual total sales of all products manufactured by Gilmour Co. for at least a 5-year period were available and may have been used by Smith. It is not clear whether complete production and sales records for each product manufactured under patent were available but it is clear that no such records were used by Smith in making his valuation.

[9] Smith used a 17-year useful life as the factor in computing the value for the card-packaging invention. This figure was presumably used because at the time of the stock purchase Smith contemplated patenting this invention; in fact a patent was obtained in 1972.

During Johnston's period of employment with Gulf, he had no experience in examining and determining the value of patents. Johnston testified that his sole experience with regard to patent valuation has been in connection with his work as a financial appraiser and that since 1963 he has appraised 15 different patents. He has had no previous experience in connection with a transaction involving either the transfer or sale of patents; nor has he ever previously testified as an expert witness in establishing patent values.

Johnston's general approach in determining the values of the patents and invention of Gilmour Co. included obtaining and studying the financial reports of Gilmour Co., going to the company's plant and observing the manufacturing process, viewing the company's patented products, and considering Gilmour Co.'s past sales history[10] and Smith's opinion as to future sales. The method used by Johnston to make his evaluations was to estimate the earnings petitioner could realize from royalties if it were to grant exclusive unlimited licenses for the use of the patents for their remaining legal lives as of March 31, 1970. Computations were made using estimated dollar amount of sales of the item covered by the patent for the year 1970, projecting estimated future sales during the life of the patent by applying an estimated annual growth rate (usually 12½ percent compounded per annum) to the preceding year's sales, and then determining the estimated average annual sales during the remaining life of the patent. This was multiplied by the percentage royalty Johnston thought was justified (7½ to 10 per-

[10] The records of Gilmour Co.'s sales used by Johnston were those of total sales of all products, both patented and nonpatented; he used no records which identified sales of individual products manufactured, see fn. 8, p. 18, *supra*. None of the records of Gilmour Co. were offered in evidence.

cent) to obtain the estimated royalty income value per year. The latter was multiplied by the number of remaining years in the life of the patent to get a gross royalty value of the patent. The gross value was then reduced to present (1970) value by applying what is commonly referred to as "Hoskhold's formula."[11]

With respect to the nozzle packaging invention, which was not patented in 1970,[12] Johnston arrived at a value for this "know how" or invention by determining that this method of packaging would save petitioner $5.20 per thousand units packaged over petitioner's cost of packaging its products under its prior method, and then multiplying the number of packages that would be used over the next 10 years by $5.20 per thousand to arrive at a gross value of the invention, which was then reduced to 1970 value by applying Hoskhold's formula. Johnston determined estimated sales by applying an estimated 12½-percent compounded annual growth rate to the 1970 sales which presumably utilized the package. Since the package was not patented in 1970 Johnston assumed that the value of the package would last 10 years before being replaced by a better method of packaging nozzles and other garden products.

At trial respondent called as its sole expert witness James P. Burns. Burns is an attorney specializing in the field of patent law; he is currently the senior partner of a Washington D. C. law firm which limits its practice to patent, trademark, and

[11] Hoskhold's formula is a sinking fund method of valuation by which the taxpayer receives an assumed specified rate of interest on his capital (the present worth of estimated future earnings), and the capital is returned to the taxpayer by annual payments to a sinking fund accumulated at 4 percent interest, compounded annually. Hoskhold, Engineer's Valuing Assistant, 2d Ed. London, 1905.

[12] A patent was issued on the package in 1972.

unfair competition law. Burns has had about 50 years of experience in the area of patent law beginning in the early 1920's with his work as a patent examiner in the United States Patent Office. During his career Burns has served as president of the American Patent Law Association and many professional committees including an advisory committee to the Secretary of Commerce with respect to patents. Burns' experience with respect to patents includes determining fair market values of patents, patent infringements including the assessment of damages arising therefrom, licensing of patents, and advising clients with respect to proper royalty rates to be received or paid upon the sale, licensing, or acquisition of patents.

In determining the fair market values of the Gilmour Co. patents Burns took into consideration: The scope of the patent; the prosecution history of the matter being patented to determine whether any part thereof was already in the public domain or was anticipatory or whether any patent claim was given up as a condition precedent to the grant of a new patent; what, if any, competitive products can be marketed royalty-free; and the potential market including the range and magnitude for the patented products and the price range at which the product sells.

Burns utilized the same computational formula for determining fair market value of the patents as was used by Johnston, except that the gross values determined were not reduced to current cash values. Burns usually used Johnston's estimated sales for 1970 but, for reasons stated in his appraisal reports including consideration of the above-mentioned factors, Burns used a significantly lower estimated compounded annual growth rate of sales to arrive at estimated annual sales of the patented products, and also a lower percentage royalty (usually 3 percent) to determine the royalty value of the patents. With respect to the wave

sprinkler (Patent No. 3,498,543), Burns concluded that the design or mechanical improvements covered by the Gilmour patent were preempted by a Jepson patent which did not expire until 1977, so this gave the Gilmour patent a negative value for 7 years (to cover the royalty that would have to be paid to Jepson if the sprinkler was marketed), thus reducing the overall value of the patent. With respect to the dual barrel spray head (Patent No. 3,207,443) Burns concluded that it provided nothing new and assigned only a nuisance value to it. And with regard to the nozzle card package, Burns concluded that the patent, when issued in 1972, was invalid and assigned it only a nominal value for going concern "know how."

The appraised values of the various patents and invention determined by the three appraisers who testified as to the values of the patents were as follows:

Pat. No.	Item	Johnston	Burns	Smith	Smith reduced
D 194,014	Pistol-grip nozzle	$1,136,000	$202,246	$ 202,500	$ 145,000
3,045,927	Jet Speed nozzle	18,000	7,000	3,325	3,000
RE 26,013 et al.	Thum Trol nozzle	59,000	14,745	123,959	90,000
3,191,869 et al.	Sprayer	366,000	127,656	1,421,875	1,025,000
3,207,443	Dual Spray-head	10,000	5,000	76,000	55,000
3,498,543	Wave Sprinkler	278,000	68,000	510,000	365,000
Invention	Card package	130,000	10,000	204,000	150,000
Total		$1,997,000	$434,647	$2,542,505	$1,833,392.53[13]

[13] This includes $392.53 for the value of Design Patent 189,411—Spray Nozzle, about which we have no evidence and neither Johnston nor Burns appraised.

Gilmour Co. operated a successful business operation. In each of its taxable years since at least 1964 through its liquidation on March 31, 1970, Gilmour Co. operated at a profit. After its liquidation, petitioner uninterruptedly continued the business operation of Gilmour as a division of R. M. Smith, Inc., and continued to use the trade names of Gilmour and Gilmour Co. Petitioner acquired a substantial customer list from Gilmour and continued to use substantially the same sales representatives for its products as had Gilmour Co. prior to its liquidation.

Prior to the stock acquisition by petitioner, Gilmour Co. sold its products under the trademark of "Hosemaster." Upon the liquidation of Gilmour Co. petitioner acquired the "Hosemaster" trademark and has, to a certain extent, continued its use. The "Hosemaster" trademark is displayed prominently on petitioner's sales catalogues, and on its sales display packages for pistol-grip, jet-speed, and thum-trol nozzles as well as the display packages for the various sprinklers marketed by petitioner. In addition, the trademark "Hosemaster" is displayed on a globe which is attached to the top of a large pylon that stands outside petitioner's manufacturing plan and can be seen from the Pennsylvania turnpike.

The corporate income tax return of Gilmour Co. for the period July 1, 1969 to March 31, 1970, was prepared by Robert M. Smith. Said return did not report any income from the recapture of depreciation and investment credit previously taken by Gilmour Co. with respect to certain assets owned by it which were distributed to petitioner upon liquidation. Petitioner has conceded that Gilmour Co. should have reported income from the recapture of depreciation and investment credit on its final return.

Smith has had an extensive background in a tax and accounting practice. Smith began work as an accountant with the Pittsburgh office of Haskins & Sells in December 1938. From July 1941 through March 14, 1948, Smith practiced public accounting with the firm of Davies-Silverstone & Co. in Johnstown, Pa. Smith became a certified public accountant in the State of Pennsylvania in 1945.

In his accounting practice Smith represented clients in over 100 cases with the Internal Revenue Service at various levels. And as a CPA and tax practitioner, Smith was cognizant of the depreciation and investment credit recapture provisions of the Internal Revenue Code. A depreciation recapture issue was involved in one of the cases in which Smith represented a client before the Internal Revenue Service.

Smith testified that he hastily prepared the income tax return of Gilmour Co. for the period ended March 31, 1970.

Ultimate Findings of Fact

The fair market values of the patents and invention received by petitioner in liquidation of Gilmour Co. were as follows:

	Pat. No.	Item	FMV
1	D 194,014	Pistol-grip nozzle	$355,000
2	3,045,927	Jet speed nozzle	11,000
3	RE 26,013 et al.	Thum Trol nozzle	25,000
4	3,191,869 et al.	Sprayer	220,000
5	3,207,443	Dual sprayhead	9,000
6	3,498,543	Wave sprinkler	125,000
	Invention	Card package	115,000
	Total		$860,000

Upon the liquidation of Gilmour Co. petitioner received valuable intangible assets including a trademark, goodwill, and going concern value.

Petitioner failed to prove that the underpayment of tax by Gilmour Co. for the taxable period beginning July 1, 1969, and ending March 31, 1970, was not due to negligence or intentional disregard of rules and regulations.

The following findings of fact are made to reflect concessions of the parties on certain issues:

1. Gilmour Co. is entitled to deductions for rent expense of $6,000 and a consultant fee of $4,000 paid to Robert A. Gilmour during the period ending March 31, 1970.[14]

2. Gilmour Mfg. Co. is not entitled to a deduction for depreciation in the amount of $646.87 for the period ended March 31, 1970.

3. Depreciation in the amount of $189,950.16 for the period ended March 31, 1970, should have been recaptured by Gilmour Mfg. Co. under section 1245 as gain taxable as ordinary income upon the liquidation of said company.

4. Gilmour Mfg. Co. should have recaptured investment credit in the amount of $13,596.34 for the period ended March 31, 1970, upon the liquidation of Gilmour Mfg. Co. as there was a disposition of section 38 property within the meaning of section 47.

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[14] Since respondent appears to have conceded all issues which were dependent upon whether the transaction between Smith and Gilmour was effective as of January 31, 1970, or March 31, 1970, we find no need for us to determine the effective date.

5. Petitioner is entitled to deductions of $6,515.73 and $5,572.71 for "interest expense—others" in the fiscal years ended August 31, 1970, and August 31, 1971, respectively.

6. Petitioner is entitled to deductions of $5,962.69 and $7,863.31 for "interest expense—stockholders" in the fiscal years ended August 31, 1970, and August 31, 1971, respectively.

7. Petitioner did not have dividend income of $280,550 from Gilmour Mfg. Co. on or about March 24, 1970.

8. Petitioner is not entitled to a dividend received deduction of $238,467.50 for the year 1970 as set forth in the notice of deficiency, as respondent conceded that petitioner did not have dividend income of $280,550.

9. Gilmour Mfg. Co. did not have a gain on sale of machinery and equipment, building and landscaping, and airplane hangar in the amount of $12,360.42 in 1970.

OPINION

We must decide two questions herein: (1) Whether petitioner overstated deductions for depreciation or amortization of patents and an invention claimed on its corporate tax returns for fiscal years ended August 31, 1970 and August 31, 1971; and (2) whether Gilmour Co. is liable for an addition to tax under section 6653(a) for the taxable period July 1, 1969 to March 31, 1970.

Effective February 1, 1970, petitioner purchased all of the stock of Gilmour Co. from R. A. Gilmour and soon thereafter began the liquidation of Gilmour Co., which was completed on March 31, 1970. Petitioner paid $3,500,000 for all the stock of Gilmour Co., plus the fair market value of cer-

tain nonoperating assets of Gilmour Co. which were immediately sold to R. A. Gilmour at the same fair market value. Upon the liquidation of Gilmour Co. petitioner allocated the $3,500,000 purchase price of the stock among the assets received by petitioner as a result of the liquidation of Gilmour Co. Petitioner allocated to the tangible assets received, and to the inventory and accounts receivable, a total of $1,615,400.19, and the balance of the purchase price, or $1,884,599.81, to certain patents and an invention owned by Gilmour Co. at the time of the liquidation. Petitioner allocated nothing to intangibles such as goodwill, tradename, and going concern value. On its income tax returns for the periods ending August 31, 1970 and 1971, petitioner claimed deductions for amortization of the patents and invention, using as a tax basis the values allocated thereto as above indicated. Upon audit of those returns respondent determined that petitioner had a tax basis of only $10,000 in one of the patents and no basis in the others and disallowed all but a small amount of the patent amortization deductions claimed by petitioner.

The parties have stipulated the values of the tangible assets, accounts receivable and inventories received by petitioner on the liquidation of Gilmour Co., which total $1,501,819. Hence, the principal issue remaining for our determination is the fair market value of the patents and invention, and if that together with the stipulated value of the tangible assets, accounts receivable, and inventories is less than the purchase price of the stock, whether the balance should be allocated to goodwill and other nondepreciable intangible assets or to the depreciable and amortizable assets.

Petitioner also failed to include in the final return of Gilmour Co. recapture of depreciation mandated by law, and the secondary issue remaining for our decision is whether the underpayment of tax resulting therefrom was due to negligence or intentional disregard of rules and regulations so as to make the addition to tax imposed by section 6653(a) applicable.

Section 167(a)[15] provides that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, including obsolescence, of property used in a trade or business. For purposes of this case, as is indicated in the regulations, see sec. 1.167(a)-1, Income Tax Regs., the amount of the allowable deduction for depreciation is computed with respect to the basis and useful life of each particular asset. Gilmour Co. was liquidated tax free in accordance with section 332 and it is uncontested that petitioner's basis in the assets thus received is governed by section 334(b)(2).

[15] SEC. 167. DEPRECIATION.

(a) General Rule.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

Under section 334(b)(2)[16] the basis of the property received in liquidation by petitioner is petitioner's adjusted basis in the Gilmour Co. stock with certain adjustments thereto as prescribed in the regulations. Under section 1.334-1(c), Income Tax Regs., the aggregate basis in the assets received by petitioner is the cost of the Gilmour Co. stock reduced by the amount of cash received and increased by the liabilities

[16] SEC. 334. * * *

(b) Liquidation of Subsidiary.—

* * *

(2) Exception.—If property is received by a corporation in a distribution in complete liquidation of another corporation (within the meaning of section 332(b)), and if—

(A) the distribution is pursuant to a plan of liquidation adopted—

(i) on or after June 22, 1954, and

(ii) not more than 2 years after the date of the transaction described in subparagraph (B) (or, in the case of a series of transactions, the date of the last such transaction); and

(B) stock of the distributing corporation possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote, and at least 80 percent of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends), was acquired by the distributee by purchase (as defined in paragraph (3)) during a 12-month period beginning with the earlier of,

(i) the date of the first acquisition by purchase of such stock, or

(ii) if any of such stock was acquired in an acquisition which is a purchase within the meaning of the second sentence of paragraph (3), the date on which the distributee is first considered under section 318(a) as owning stock owned by the corporation from which such acquisition was made,

then the basis of the property in the hands of the distributee shall be the adjusted basis of the stock with respect to which the distribution was made. For purposes of the preceding sentence, under regulations prescribed by the Secretary or his delegate, proper adjustment in the adjusted basis of any stock shall be made for any distribution made to the distributee with respect to such stock before the adoption of the plan of liquidation, for any money received, for any liabilities assumed or subject to which the property was received, and for other items.

assumed or subject to which the property was received.[17] After the prescribed adjustments are made to the adjusted basis, said aggregate basis is then allocated among the various assets received in the liquidation (except cash and its equivalent) both tangible and intangible, ordinarily in proportion to the net fair market values of such assets on the date received, see sec. 1.334—1(c)(4)(viii), Income Tax Regs., and as such constitutes the individual basis for each asset in the hands of the petitioner.

Petitioner now contends that the aggregate fair market value of the patents and invention as of March 31, 1970, was $1,997,000, Johnston's aggregate appraisal figure. Upon petitioner's argument, the portion of petitioner's adjusted basis in the Gilmour Co. stock, as finally adjusted, which was not allocated to the tangible assets is allocable to the patents and invention in proportion to their respective fair market values. Furthermore, petitioner apparently contends that after the aggregate basis has been allocated to the tangible assets and to the patents and invention under section 334(b)(2), if any amount thereof remains it should be reallocated pro rata among all of the assets both tangible and intangible in accordance with their respective fair market values.

Respondent now contends, based on the testimony and valuation report of his expert witness, James Burns, that the aggregate fair market value of the patents and invention, as of

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[17] Sec. 1.334-1(c)(4)(v), Income Tax Regs., specifies the adjustments which are to be made to the petitioner's adjusted basis of the subsidiary's stock which include, in addition to those for cash and liabilities indicated in the text above, certain adjustments on account of the earnings and profits, or deficit thereof, realized by Gilmour during the period beginning February 1, 1970 through March 31, 1970. We received no evidence in this respect but any necessary adjustment can be made by the parties in the Rule 155 computation.

March 31, 1970, did not exceed $434,647, that petitioner received additional valuable intangible assets from the Gilmour Co. liquidation including a trademark and goodwill, and that the remaining part of the stock purchase price should be allocated under section 334(b)(2) to these nondepreciable intangible assets. Respondent proposes that, for purposes of allocating the basis to the assets received from Gilmour Co., we should adopt a so-called "residual appraisal method," *i.e.*, basis is allocated to depreciable assets according to their respective values and the remaining or residual amount of basis is allocated to nondepreciable assets.

We agree with respondent that petitioner improperly overvalued and allocated an excessive amount as basis to the depreciable intangibles received in liquidation and in fact received valuable nondepreciable intangible assets to which a portion of the available amount of basis should have been allocated pursuant to section 334(b)(2) and the regulations thereunder. We also agree with petitioner, however, that respondent's allocation of only $10,000 of that basis to the patents and invention was arbitrary and unreasonable and that the presumption of correctness which normally attached to respondent's determination is not applicable with regard to this issue. This leaves us with the burden of determining the value of these patents and the invention, which at best is a will-o'-the-wisp exercise, from the evidence presented during the trial of this case, without support of a burden-of-proof rule.

We have described in some detail in our findings of fact the approaches taken by the three witnesses in determining the values of these assets, the mechanics used to carry out those approaches, and the amount of the values so computed. While the testimony and appraisal reports of those witnesses were

helpful, after a careful review of all of the evidence presented herein, we have concluded that the parties have overstated their cases, and, as a result, have exaggerated their appraisals. Consequently, in making our determination, we have not sustained either of the parties' valuations because we believe the answer lies somewhere between the two extremes and have made our findings accordingly.

At the outset we note that the opinion evidence submitted was somewhat less than exemplary. Our basic criticism of the evaluation reports concerns the data upon which the reports are based and from which the conclusions contained therein were necessarily drawn; they seem to us unduly speculative. We recognize that the process of making determinations of value is by its nature speculative and that the subject matter concerned herein, patents, which by their nature are unique, serves to exacerbate the uncertainties inherent in an evaluation determination (see *Simmons Company* [Dec. 2909], 8 B. T. A. 631, affd. [5 USTC ¶ 1569], 33 F. 2d 75 (1st Cir. 1929), cert. denied 280 U. S. 588 (1929)). Nevertheless, conjecture should be kept to a minimum by establishing, where possible, a firm factual foundation from which necessary projections can be made with some degree of confidence.

In this case both parties' experts made their evaluations of the patents on the basis of projected future earnings. These projections, which theoretically represent a consideration of the reasonable prospects for the future, were, in turn, based upon the earnings history of Gilmour Co. for the 5-year period immediately preceding March 31, 1970. However, the

historical earnings figures used by the experts[18] as the basis for their projections were in fact estimates made by R. M. Smith and did not represent actual historical data in which earnings or sales from products were segregated to reflect those amounts related to specific patents. Moreover, the figures from which Smith made his estimates did not even reflect a distinction between sales of nonpatented products from those manufactured under patent. There was testimony at trial to the effect that production records of Gilmour Co. do exist and are and were available. We do not know how informative such records might be nor what time periods they may reflect but it is clear that no such records were resorted to in compiling the valuation reports submitted herein.[19]

By our criticism we do not mean to cast aspersion on either of the parties' expert witnesses. Clearly, Burns, respondent's expert, is an attorney of great stature in his field and a review of his accomplishments and professional contributions is indicative of this fact. Moreover, Burns' experience in advising clients as to the fair market values of various patents evidences his competency to testify as an expert witness in this proceeding. Petitioner's expert, Johnston, although not

[18] Although Burns did not actually use the same figures as Johnston in making his determinations, the figures that he did use were not the result of independent research. The sales figures used by Burns in his calculations were the result of his rejection of the figures used by Johnston as unrealistic, followed by Burns' rather arbitrary selection of other amounts.

[19] Although respondent, on brief, challenges the credibility of Johnston's evaluation on this basis, he cannot escape some responsibility for the lack of reliable data when, as it appears herein, he made no effort through means of discovery, to acquire Gilmour's production records. This is not a situation where respondent can rely upon the burden which falls on petitioner because respondent's determinations are presumptively correct.

possessing much experience in evaluating patents, is a senior member of the American Society of Appraisers and testified as an expert herein without objection from respondent. Furthermore, the methods used by these experts to evaluate the patents, which methods were essentially the same, represented appropriate means by which to determine fair market values—attempts to determine at what price the patents would change hands between a willing buyer and seller. See *Bendix Engineering Works, Inc.* [Dec. 7086], 23 B. T. A. 1049 (1931); *Nice Ball Bearing Co.* [Dec. 1906], 5 B. T. A. 484 (1926); *Harry W. Bockhoff* [Dec. 1195], 3 B. T. A. 560 (1926).

However, we find the method used by petitioner's president, R. M. Smith, to evaluate the patents wholly unacceptable, having no apparent relation to what a willing buyer and seller might agree upon at arm's length. At first blush it may seem incongruous to ignore the testimony of the individual who negotiated the purchase of Gilmour stock on behalf of petitioner. However, the transaction which Smith negotiated was a lump-sum purchase of stock of a profitable ongoing business, payable in installments. Such experience does not necessarily indicate Smith's capability of accurately determining the fair market values of the patents. It should be clear, however, that our refusal to give weight to Smith's testimony with respect to the valuation of the patents is not predicated upon a finding that he is incompetent to give such testimony. Rather, our decision was made after reviewing his testimony as to the method he used to determine such values. The method Smith used was described earlier in our fact findings and further discussion thereof is unwarranted except to say that generally it consisted of comparing the net sales price of the product manufactured under the particular patent being evaluated with the net sales price of a similar product

which is either manufactured under another patent or without patent protection. From this comparison, Smith determined the sales price differential and treated this amount, called "unit value," as the royalty petitioner would receive if the patent were licensed. We fail to see any logical relationship between differences in prices of items manufactured and sold by petitioner and the royalty amount another manufacturer would pay to obtain the right to manufacture and sell a patented item.[20]

Furthermore, as sole owner of petitioner, it was very much to Smith's advantage to allocate the largest part of the basis available to those patents which had the shortest remaining lives for amortization deduction purposes. To illustrate, we note that on the final return of Gilmour Co. for the period July 1, 1969 to March 31, 1970, gross profit on sales was reported as $959,609.14 and taxable income was reported as $303,053.04, whereas on the return of petitioner for the period September 1, 1970 through August 31, 1971, gross profit on sales from the Gilmour division was reported to be $1,012,102.82, operating expenses of that division, including an amortization deduction of $157,913.52, were reported as $993,933.06, and net operating income was reported as $18,169.76. We are also curious to know why Smith did not give us some information concerning Gilmour's breakdown of his $3,500,000 original asking price for the operating assets of Gilmour Co.; and in fact why Gilmour was not called as a witness. Under the circumstances we can give little weight to Smith's valuation of the patents and invention.

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[20] As indicated in our findings, see p. 101, *supra*. Smith used a different method to evaluate two of the patents. However, it is quite obvious that such method was no better than that rejected in the text above.

Johnston determined an aggregate fair market value for the six patents under examination of $1,867,000. In determining the values of the patents, generally Johnston used royalty rates of 10 and sometimes 7½ percent and projected future sales over the remaining lives of the patents based on an assumed annual sales increase of 12½ percent.

Burns determined an aggregate gross fair market value for the patents of $424,647. Burns assigned only a nominal value to some of the patents and to others he applied a 3-percent royalty rate to the average of sales during the lives of the patents assuming a 6-6½-percent annual compounded growth rate.

Neither of the parties has brought to our attention, nor have we discovered, an established royalty rate or range thereof applicable to lawn and garden supplies or equipment. However, it seems to us rather clear that the rates chosen by Johnston were excessively high. None of the patents under evaluation were basic, conferring a monopoly of commercial importance. Rather, each of the patents contained claims which were improvements to the existing art and in most cases rather narrow. *Garden City Feeder Co.* [Dec. 9611], 35 B. T. A. 770, 780 (1937); *Keystone Steel & Wire Co.* [Dec. 5181], 16 B. T. A. 617, 621 (1929); *Cheatham Electric Switching Device Co.* [Dec. 363], 1 B. T. A. 984, 988 (1925). At trial Johnston cited an example in which a 10-percent royalty was paid for the rights to a patented invention. However, the example chosen involved a very sophisticated invention in the electronics industry the sales of which yielded a 40-percent net profit before taxes. Obviously, petitioner's patents, design and mechanical, relating to hose nozzles and sprayers, do not

compare favorably with such highly sophisticated electronic devices.[21]

However, the royalty rates applied by Burns were too low. In most instances weighing heavily in his selection of appropriate rates was his opinion that the validity of a number of the patents was open to serious question. We believe this was an erroneous guide for choosing an appropriate royalty rate. In cases wherein the value of patents was sought to be determined courts have generally reacted negatively to evidence or opinions of their invalidity in the absence of evidence of infringement litigation. In the case of *B. F. Sturtevant Co. v. United States* [37-1 USTC ¶ 9064], 18 F. Supp. 28, 33-34 (D. Mass. 1937), the court refused to receive evidence, similar to that cited by Burns as support for his opinion, as to the validity of patents, on the grounds that such evidence was immaterial. In *Joseph H. Adams* [Dec. 6936], 23 B. T. A. 71, 103 (1931), we rejected a similar attack on certain patent applications indicating that "* * * we must accept the patents as valid * * *" and that a "* * * collateral attack may not be made in this proceeding upon the action of the Patent Office * * *." And in *Syracuse Food Products Corporation* [Dec. 6577], 21 B. T. A. 865, 885 (1930), we rejected one expert's valuation as too low because it was based upon his opinion that the patents under consideration therein were invalid. We explained: "We have no reason to believe that the question of doubtful validity would have been present in the mind of a prospective purchaser of these patents to any greater degree

[21] We note that in Sec. 9 of the consulting agreement between petitioner and Gilmour it was provided that if Gilmour developed any product which may be patented, "he shall offer the same to the Company for a royalty equal to one and one-half per cent of the net sales by the Company of such patentable products over the life of the patent."

than might be reasonably anticipated in any ordinary case of a purchase and sale of patents." Cf. *Zouri Drawn Metals Co.* [Dec. 2949], 8 B. T. A. 853, 855 (1927); and *Van Kannel Revolving Door Co.* [Dec. 3940], 11 B. T. A. 1209, 1213 (1928).

With respect to the projections made by the expert witnesses of the average estimated future sales attributable to the patents, once again Johnston was overly optimistic and Burns unduly pessimistic. As pointed out in our earlier criticism, the so-called historical sales figures of patented products were somewhat suspect and that must be taken into account in determining a reasonable estimate. Additionally, we think unrealistic an assumption that sales of patented products such as these will grow by 12½ percent each year over the patents' remaining lives as Johnston has assumed. Although Gilmour Co.'s average growth rate for all sales was 11½ to 12½ percent during the 5-year period immediately preceding March 31, 1970, *i.e.*, 1965-1969, we believe it more reasonable to presume that the sales of inexpensive items covered only by improvement patents would be more likely to decline towards the end of the patents' legal lives, especially where, as here, fierce competition exists and is likely to increase, and that this fact should not be overlooked in making a valuation determination. Also Johnston's projection gave no recognition to the effect Gilmour Co.'s trade name, "Hosemaster" and its place in the market might have had on sales of the patented items.

On the other hand, Burns, in his valuations simply rejects the sales figures used by Johnston and arbitrarily selected much lower amounts. Even though we have criticized the source of the sales figures Johnston used, there was credible testimony at trial supporting the fact that Gilmour enjoyed

substantial sales of its patented products. And it is clear that Gilmour Co. had considerable overall sales and was a profitable enterpise; Burns' determination did not give sufficient weight to these facts. Burns was correct in focusing attention to the competition that petitioner would face in marketing its patented products. Nevertheless, the fact is that the competition which Burns cited had existed prior to March 31, 1970, and yet Gilmour still enjoyed considerable sales success. Consequently, we believe Burns overemphasized the effect of petitioner's competition. We also believe that the effect upon Burns' opinion as to the validity of the various patents was pervasive in his evaluations and have taken this into consideration.

There is one other factor which we believe has some unquantifiable degree of significance in evaluating these patents: The fair market values determined by Burns were gross amounts,[22] *i.e.*, not reduced to current cash values, and yet respondent, while using the method of projecting estimated earnings over the lives of the patents to establish accurate values, a method which is meaningless unless the gross amounts are reduced to current values, urges us to sustain these gross amounts. We believe implicit in this situation is the fact that respondent recognizes the potential for error in his determination and that such error has been resolved in his favor.

After giving careful consideration to testimony received, the valuation reports submitted, and the parties' arguments on brief, we have done the best we could to make a

[22] Burns did indicate in his valuation report that reduced to terms of current cash value as of March 31, 1970, his aggregate determined fair market value of the patents and invention would be approximately $350,000.

reasonable determination of the fair market value of the patents as of March 31, 1970, and, using the same approach used by Johnston and Burns, have computed an aggregate amount of $745,000, delineated as follows:

Patent No.		
1	Pistol-grip nozzle	$355,000
2	Jet-speed nozzle	11,000
3	Thum-Trol nozzle	25,000
4	Sprayer	220,000
5	Dual-barrel spray head	9,000
6	Wave sprinkler	125,000
		$745,000

We do not understand respondent to contest the use of the respective remaining legal lives of the above patents, as of March 31, 1970, as their useful lives for purposes of amortization by petitioner and accordingly we so hold.

To this point our discussion has not encompassed the valuation of the "carded nozzle packaging invention" received by petitioner from Gilmour Co. We have delayed such discussion until now because we believe that, by the nature of the subject matter, this asset should be considered separately from the patents.

In the context of this proceeding the value of certain property is sought, as of March 31, 1970. Necessarily, the property rights under consideration must be examined as of that date. Under the facts herein, prior to its liquidation, Gilmour Co. did not possess any statutory patent rights with respect to the carded nozzle packaging process. Rather, as of March 31, 1970, Gilmour possessed and transferred to petitioner only a right, recognized under common law, to

make, use, sell, and otherwise enjoy this invention. See *Patterson v. Kentucky,* 97 U.S. 501, 507 (1878).

Therefore, we proceed to examine the evidence with respect to the value of this carded nozzle packaging invention with the understanding that as of March 31, 1970, the property right received by petitioner was the above-described common law inventor's right.

Johnston determined that the fair market value of this invention was $130,000. He computed this amount on the basis of the expected labor cost savings to be realized over a 10-year period in packaging pistol-grip nozzles, and reduced the amount of the estimated savings to current cash value as of March 31, 1970. Burns determined a nominal value of $10,000 for this invention for the most part due to the numerous competitive packaging methods.

Reasonably anticipated labor cost savings resulting from the implementation of a patented invention have been found to be an appropriate basis for determining a value for such an invention. *Westclox Co. v. United States* [2 USTC ¶ 462], 37 F. 2d 191 (Ct. Cl. 1930). However, as that case points out the savings from which the value is determined is the amount of savings the petitioner will realize in comparison with the costs incurred by its competitors under the methods they use to package their products. See *Westclox v. United States, supra* at p. 195; cf. *Keystone Steel & Wire Co., supra* at p. 621. Petitioner's valuation of this invention was not based upon comparative cost savings nor may it be safely assumed that petitioner's competitors used petitioner's old method for packaging their products or that they incurred the same labor costs as did petitioner.

Nevertheless, we are of the opinion that this carded nozzle package developed by Gilmour Co. had inherent value to petitioner as of March 31, 1970. Not only did it save petitioner labor costs but it had a marketing appeal. By use of this device petitioner's products could be displayed on the sales floor in a manner that would permit potential customers to remove the product from the card to examine it and then to replace it without damage to the card. The competitive packages which employed either staples or plasticized coverings did not have this advantage. In 1970 Gilmour Co. had the going concern "know how" to utilize this device and whether it obtained a patent on the device or not would relate more to the length of time petitioner could enjoy the marketing advantage than its value to petitioner in 1970. Taking all factors into consideration, we find that the fair market value of the carded nozzle packaging invention as of March 31, 1970, was $125,000.

Consideration of the proper period over which petitioner's basis in the invention may be amortized is a bit more complicated than that necessary with respect to the patents discussed *supra*, although neither party makes specific reference to this factor on brief. We recognize that it has been held that a patent application has no definite period of useful life and is not the proper subject of exhaustion, *Hershey Manufacturing Co.* [Dec. 4697], 14 B. T. A. 867, 873 (1928), affd. [2 USTC ¶ 573] 43 F. 2d 298 (10th Cir. 1930), and that it can be argued that the life of a common-law inventor's property right is likewise indeterminable. However, we believe the carded nozzle invention had a limited life probably shorter than the life of most patents. As of 1970 we would accept Johnston's estimate of 10 years and hold that petitioner is entitled to a deduction for amortization of the

value we have allocated to the invention based on a 10-year life. We make no determination with respect to the rate of amortization that would be applicable if the invention is patented.

Having determined that the aggregate fair market value of the patents and invention received by petitioner from Gilmour Co. was $860,000 as of March 31, 1970, one further question remains with respect to the proper allocation of basis under section 334(b)(2). As discussed *supra*, section 334(b)(2) and the regulations thereunder require an allocation of petitioner's adjusted basis in the Gilmour Co. stock among *all* of the assets petitioner received in liquidation in accordance with their respective fair market values. As a result of the parties' stipulation and their respective concessions as to the tax liability of Gilmour Co. asserted against petitioner herein as transferee, the parties may compute the correct amount of petitioner's adjusted basis in the Gilmour Co. stock under the Rule 155 computations. The parties have stipulated the fair market values of all the tangible assets received by petitioner, and we have determined the fair market values of the patents and invention received. However, the sum of the fair market value of these assets clearly will be less than the amount of the adjusted basis when finally calculated and a controversy exists as to what this amount represents and as to how it is to be treated in this proceeding.

Respondent contends that upon the liquidation of Gilmour Co. petitioner received valuable assets, in addition to the tangible assets and the patents and invention already enumerated, namely a trademark and goodwill. Respondent argues that the residual amount of petitioner's adjusted basis in the Gilmour stock not absorbed by the value of the patents and invention, the value of the tangible assets, and the

amount of cash received in the liquidation is attributable to the value of said intangible assets in accordance with the so-called residual method of valuing goodwill.

Petitioner vigorously contests respondent's position. Petitioner argues that although a trademark and certain assets, which have been recognized in the past as indicia of goodwill, were received from Gilmour, those assets were of nominal value only. And, although petitioner steadfastly maintains that we should sustain its asserted valuation of the patents and invention, petitioner belatedly argued that if we should decide that the fair market values of the patents and invention were of lesser amounts than petitioner has claimed, nevertheless, the value of the trademark and goodwill should not be determined under the residual method. Rather, petitioner urges, as best we can understand it, that a specific determination of the fair market value of the trademark and goodwill must be made, which petitioner maintains would leave a portion of petitioner's adjusted basis in Gilmour Co. stock to be reallocated among all of the liquidated assets in proportion to their respective fair market values.

Notwithstanding its argument to the contrary, we find that upon the liquidation of Gilmour Co. petitioner received intangible assets of substantial value to which it erroneously failed to assign any portion of its basis, as adjusted, in the Gilmour stock. Consequently, we have no doubt that the amount of depreciation and amortization claimed by petitioner for the tax years in question was excessive. Furthermore, we hold that under the facts of this case the aggregate value of the previously unaccounted for intangible assets is to be determined under the residual method of valuation as argued by respondent.

Not only do we find that the residual method of valuing those intangible assets is appropriate under the circumstances of this case, but we also believe that the evidence justified the value that will be allocated to those assets under such method. As noted in our findings of fact, petitioner received in the liquidation an ongoing profitable business that had been marketing lawn and garden equipment for a number of years under the name "Gilmour Manufacturing Co." and the trademark "Hosemaster." After the liquidation petitioner continued the same business in the same markets identifying its products by the names "Gilmour Manufacturing Co." and "Hosemaster." Despite Smith's testimony to the contrary, we believe it is obvious that those names and the products identified therewith were well and favorably known to the users of lawn and garden equipment and promoted sales of these products. It matters not whether petitioner sold its products through jobbers or direct to the consumers—the fact that sales to consumers were promoted by these names and the position of Gilmour Co. in the market would filter through the jobbers to constitute a valuable asset, goodwill, of Gilmour Co. which petitioner acquired and used. The fact that petitioner retained most of the customers of Gilmour Co. bolsters that conclusion, even though those customers were jobbers for the most part.

Gilmour Co.'s marketing program for its products included the use of sales representatives in numerous States, in Canada, in Venezuela, and one representative for other countries. These representatives were responsible for ensuring that petitioner's products were carried by various jobbers and hundreds of retail outlets throughout the United States and elsewhere. To attribute the success of Gilmour to the patented products and ignore the effect of good management and a

good marketing program is erroneous. As we commented in *Cheatham Electric Switching Device Co.* [Dec. 363], 1 B. T. A. 984, 988 (1925):

> We are unable upon consideration of the evidence in this appeal to agree with the taxpayer that its earnings are and were attributable entirely to its patents. No one of its patents covered a basic principle, and other manufacturers were, and are, free to use the same principle used by Cheatham, so long as the devices manufactured by them do not infringe upon the Cheatham device. Other devices capable of performing the same service, but not infringing upon the Cheatham device, were produced, marketed, and placed in operation, and we therefore conclude that the taxpayer's earnings were not only due to the patents it owned, but largely to good management and the ability of its salesmen to market its product in the face of competition.

See also *Auto Specialties Manufacturing Co.* [Dec. 3152], 9 B. T. A. 455, 458 (1927).

Although the trademark, goodwill, and going-concern value acquired by petitioner are separately identifiable assets, they are all nondepreciable. *Clarke v. Haberle Crystal Springs Brewing Co.* [2 USTC ¶ 466], 280 U. S. 384 (1930); *Norwich Pharmacal Co.* [Dec. 8501], 30 B. T. A. 326 (1934); *Northern Natural Gas Co. v. United States* [73-1 USTC ¶ 9152], 470 F. 2d 1107 (8th Cir. 1973), cert. denied 412 U. S. 939 (1973); and sec. 1.167(a)-3, Income Tax Regs. Consequently, in the context of this case where we are seeking assets' fair market value for purposes of a section 334(b)(2) allocation, we see no need to determine separate values for these assets. Petitioner's argument that this case does not present an appropriate occasion to value these assets under the residual method is erroneous. Indeed, the facts of this case present the exact

situation wherein the residual valuation method has been held to be applicable. *Jack Daniel Distillery v. United States* [67-2 USTC ¶ 9499], 379 F. 2d 569, 579 (Ct. Cl. 1967).

In general terms, section 334(b)(2) attempts to equate a corporate acquisition of stock followed by a liquidation of the subsidiary with an outright acquisition of the underlying assets of such a corporation. *Boise Cascade Corp. v. United States* [70-2 USTC ¶ 9595], 288 F. Supp. 770 (D. Idaho 1968), affd. per curiam [70-2 USTC ¶ 9595] 429 F. 2d 426 (9th Cir. 1970). *Cf. Argus, Inc.* [Dec. 27,592], 45 T. C. 63 (1965); and *Cabax Mills* [Dec. 31,631], 59 T. C. 401 (1972).[23] The petitioner's basis as adjusted in the Gilmour Co. stock is the best evidence of the fair market value of the assets acquired.[24] This aggregate fair market value is fractionalized under the regulations, see sec. 1.334-1(c)(4)(viii), Income Tax Regs., and allocated among all of the assets acquired in liquidation. Since we have found that petitioner received the valuable nondepreciable intangible assets enumerated above and since the petitioner's basis, as adjusted, in the Gilmour Co. stock and the fair market values of all other assets acquired in the liquidation have been or may now be determined, we hold that the value of the nondepreciable intangibles is to be determined under the residual valuation method. *Jack Daniel Distillery v. United States, supra; Philadelphia Steel & Iron Corp. v. Commissioner* [65-1 USTC ¶ 9308], 344 F. 2d 964 (3d Cir. 1965), affg. per curiam a Memorandum Opinion of this Court [Dec. 26,740(M)]; *Copperhead Coal Company v. Commissioner* [60-1 USTC ¶ 9108], 272 F. 2d 45 (6th Cir. 1959), affg. a Memorandum Opinion of this Court [Dec. 22,815(M)];

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[23] See also *Moss American, Inc.* [Dec. 32,784(M)], T. C. Memo. 1974-252.

[24] *Moss American, Inc., supra.*

Florida Publishing Co., [Dec. 33,217], 64 T. C. 269 (1975), on appeal (5th Cir. Aug. 21, 1975); see *Saline Motor Co.* [Dec. 6811], 22 B. T. A. 874 (1931); see Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, par. 11.45 at 11-44 (3d Ed. 1971).

The final issue for decision is whether Gilmour Co. is liable for the addition to tax under section 6653(a) for the taxable period July 1, 1967 to March 31, 1970.

The final corporate tax return for Gilmour Co. failed to include the income realized under section 1245, from recapture of the depreciation previously taken with respect to certain assets which were distributed to petitioner in the liquidation of Gilmour Co. R. M. Smith prepared and filed Gilmour Co.'s final return; Smith signed the return in his capacity as president of Gilmour Co. and also signed the name of his accounting firm, Smith & Martin, as preparer. Respondent determined that the failure of Gilmour Co. to report the income from depreciation recapture was due to negligence or intentional disregard of rules and regulations.

Section 6653 (a)[25] imposes an addition to tax in an amount equal to 5 percent of the underpayment if any part thereof is due to negligence or intentional disregard of rules and regulations. The taxpayer has the burden of proving that the assertion of the section 6653(a) addition to tax is erroneous. *David Courtney* [Dec. 22,425], 28 T. C. 658, 669 (1957). Petitioner makes two arguments against imposing the section 6653(a) addition to tax: (1) Since the recapture provisions do not normally apply to nontaxable transactions such as a section 332 liquidation, applying normal tax reasoning one would conclude that section 1245 was inapplicable under the facts at bar because such a tax would be borne by a corporate owner who did not receive the benefit of the deduction; (2) as a CPA, Smith was sufficiently aware of Internal Revenue Service procedures to know that the final tax return of Gilmour as well as petitioner's initial return filed subsequent to the Gilmour liquidation would both be audited as a matter of course so that technical compliance with all provisions would be expected.

Petitioner's arguments are without merit. Smith carried on a full-time accounting practice through April 15, 1970, and in his capacity as a CPA had experience with the recapture provisions of the Code. He had prepared the returns for Gilmour Co. on which the accelerated depreciation was claimed. Furthermore, the only evidence offered to explain the failure to report the depreciation recapture on Gilmour Co.'s final return was Smith's testimony that the return was hastily prepared. Gilmour Co. cannot thus escape responsibility for its duty to file accurate tax returns. See *Vern W. Bailey* [Dec. 20,146], 21 T. C. 678, 687 (1954). Under the facts of this case such a statement itself may prove negligence.[26] See *Marcello v. Commissioner* [67-2 USTC ¶ 9516], 380 F. 2d 499, 506 (5th Cir. 1967), affg. in part and remanding in part a Memorandum Opinion of this Court [Dec. 27,048(M)]. At any rate, petitioner has clearly failed to meet its burden of proof on this issue. See *David Courtney, supra*, and *Gavin S. Millar* [Dec. 34,206], 67 T. C.—(Jan. 10, 1977), and we hold for respondent on this issue.

Decision will be entered under Rule 155.

[25] SEC. 6653. FAILURE TO PAY TAX.

(a) Negligence or Intentional Disregard of Rules and Regulations With Respect to Income or Gift Taxes.—If any part of any underpayment (as defined in subsection (c)(1) of any tax imposed by subtitle A or by chapter 12 of subtitle B (relating to income taxes and gift taxes) is due to negligence or intentional disregard of rules and regulations (but without intent to defraud), there shall be added to the tax an amount equal to 5 percent of the underpayment.

[26] See also *James J. Arditto* [Dec. 30,948(M)], T. C. Memo. 1971-210.

Rehearing Denied

UNITED STATES COURT OF APPEALS

For The Third Circuit

No. 78-1442

R. M. SMITH, INC.,

Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE.

SUR PETITION FOR REHEARING

Present: SEITZ, *Chief Judge,* ALDISERT, ADAMS, GIBBONS, ROSENN, HUNTER, WEIS, GARTH, HIGGINBOTHAM, *Circuit Judges.*

The petition for rehearing filed by appellant in the above entitled case having been submitted to the judges who participated in the decision of this court and to all the other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular active service not having voted for rehearing by the court *in banc,* the petition for rehearing is denied.

By the Court,

MAX ROSENN, *Judge.*

Dated: February 23, 1979

No. 78-1632

In the Supreme Court of the United States

OCTOBER TERM, 1978

R. M. SMITH, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

WADE H. MCCREE, JR.
Solicitor General
Department of Justice
Washington, D.C. 20530

In the Supreme Court of the United States

OCTOBER TERM, 1978

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COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

The sole issue in this federal income tax case is the factual question whether the courts below correctly determined the value of nondepreciable intangible assets acquired by petitioner following the liquidation of a recently purchased subsidiary.

1. The pertinent facts may be summarized as follows: During 1970, petitioner acquired all of the stock of the Gilmour Company for \$3,780,550, to be paid by \$780,550 in cash, a 7-1/2 percent promissory note of \$300,000, and a 4 percent installment note of \$2,700,000. Shortly thereafter, petitioner liquidated Gilmour, so that its basis

in the Gilmour stock became the aggregate basis of the assets in accordance with Section 334(b)(2) of the Internal Revenue Code of 1954 (Pet. App. 21, 94).[1]

Petitioner sought to allocate the purchase price of the Gilmour stock under Section 334(b)(2) and the Regulations[2] as follows: $1,615,400.19 to depreciable tangible assets, inventory and accounts receivable, and $1,884,599.81 to patents and an invention. However, petitioner allocated no part of the purchase price to the Gilmour trade name, trademark, goodwill, and going-concern value (Pet. App. 93).[3]

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[1]Generally, the basis of property received by the parent in a distribution in complete liquidation of a controlled subsidiary is determined in accordance with the carryover basis rule of Section 334(b)(1). That section provides that the basis of property in the hands of the parent shall be the same as it would be in the hands of the subsidiary. Section 334(b)(2) of the Code, however, is an exception to this general rule. It provides that the basis of property in the hands of the parent shall be determined by reference to the adjusted basis (or cost) of the subsidiary's stock. The exception of Section 334(b)(2) is applicable if at least 80% of the stock of the subsidiary is acquired by "purchase" as defined in Section 334(b)(3), during a period of not more than 12 months, and if the distribution is pursuant to a plan of complete liquidation under Section 332 adopted not more than two years after the purchase.

[2]If the requirements of Section 334(b)(2) are met, Section 1.334-1(c)(4) of the Treasury Regulations on Income Tax (26 C.F.R.) provides that adjustments to the purchase price of the subsidiary's stock shall be made in order to determine the adjusted basis of the subsidiary's stock. The Regulation further provides that after the prescribed adjustments have been made, such amount shall be allocated as basis among the assets received by the parent in proportion to their fair market value.

[3]While the patents and the invention are depreciable intangibles, the trade name, trademark, goodwill, and going-concern value are non-depreciable intangibles. As a result, petitioner's basis allocation maximized its depreciation and amortization deductions.

On its income tax returns for the years in issue, petitioner claimed deductions for amortization with respect to the patents and the invention based upon the above allocation. On audit, the Commissioner of Internal Revenue determined that only one patent had an amortizable basis of $10,000 and accordingly disallowed petitioner's claimed deductions for amortization to the extent that they were not based upon this amount. In this action instituted by petitioner in the Tax Court (Pet. App. 22, 77), the parties stipulated that the value of the depreciable tangible assets, inventory, accounts receivable and cash that petitioner received in the liquidation was $1,967,033.52 (Pet. App. 76). The Tax Court found that petitioner received patents and an invention valued at $860,000 (Pet. App. 90). The Tax Court also found that petitioner received other valuable intangible assets including a trade name, trademark, goodwill, and going-concern value, and concluded that the value of these assets should be determined by the residual method of valuation (Pet. App. 110-111). Applying that method, the Tax Court found that the value of the nondepreciable intangibles petitioner received in the liquidation was $1,225,697.41. This amount was arrived at by subtracting the $2,827,033.52 value of all assets (other than non-depreciable intangibles) that were either stipulated by the parties or found by the Tax Court, from $4,052,730.93, which was the total consideration petitioner paid for the stock (Pet. App. 26, 39-42, 67). The Tax Court then allocated the adjusted purchase price of the Gilmour stock among the assets received by petitioner in the liquidation according to these values (Pet. App. 70). The court of appeals affirmed (Pet. App. 16-33).

2. The courts below correctly found the value of the nondepreciable intangible assets received by petitioner in the liquidation of Gilmour by applying the residual method of valuation. The theory underlying this method of valuation as applied to the lump-sum purchase of tangible and intangible assets is that where the price paid for all assets and the value of all assets (other than nondepreciable intangibles) are both known, the residuum (if any) represents the value of the nondepreciable intangibles. The courts have uniformly held that this method of valuation is a reasonable means of determining the value of nondepreciable intangibles. See, *e.g.*, *Florida Publishing Co.* v. *Commissioner*, 64 T.C. 269 (1975), aff'd mem., 552 F. 2d 367 (5th Cir. 1977) (Table); *Jack Daniel Distillery* v. *United States*, 379 F. 2d 569 (Ct. Cl. 1967); *Philadelphia Steel and Iron Corp.* v. *Commissioner*, 23 T.C.M. 558 (1964), aff'd per curiam, 344 F. 2d 964 (3d Cir. 1965); *Copperhead Coal Co.* v. *Commissioner*, 17 T.C.M. 30 (1958), aff'd, 272 F. 2d 45 (6th Cir. 1959).

Petitioner contends (Pet. 5-9) that the issue of residual value goodwill was first raised in the Commissioner's posthearing briefs, and that petitioner was thus denied the opportunity to present evidence concerning the value of goodwill. But the Tax Court's holding that the residual method of valuation was appropriate in the circumstances of this case was based on its explicit finding (which was supported by the record) that petitioner had received intangible assets of substantial value upon the liquidation of Gilmour (Pet. App. 110-111). Although petitioner could have presented contrary evidence, it chose not to do so, but elected instead to rely on its theory that nothing was allocable to goodwill. Thus, petitioner cannot now complain that it did not have an adequate opportunity to

present its case with respect to goodwill. Indeed, as the court of appeals noted, the allocation to goodwill of $1,225,697.41 was "the direct result of the amount fixed in the installment note by the parties to the sale and purchase" (Pet. App. 32 n.5). The court concluded that in these circumstances the parties who deliberately fixed the values to be placed on the elements of this transaction, could not complain of the Commissioner's construction of those values (*ibid.*).

3. Petitioner further contends (Pet. 10-14) that in determining the price paid for the stock for purposes of applying the residual method of valuation, the $2,700,000 installment note should not have been assigned its face value, but should have been discounted to its fair market value of $1,990,943[4] The almost $800,000 difference between the face value of the note and its asserted market value resulted from a decision of the parties to incorporate this economic or unstated interest into the principal part of the installment note by fixing its interest rate at less than fair market value (Pet. App. 30-31). But as the court of appeals correctly pointed out (Pet. App. 31-32):

> The argument in favor of adjustment has intuitive appeal in that greater precision is being used to derive the fair market value of an unknown. However, the effect desired by the taxpayer (increase in bases of depreciable assets) only comes about because less precision is demanded in calculating the basis in the stock. The Internal Revenue Code, 26

[4]Acceptance of this argument would result in a lower value of intangible assets, and therefore a greater allocation of basis to depreciable assets, resulting in greater depreciation deductions.

U.S.C. §483 (1976), and the underlying regulations, 26 C.F.R. §§483.1-483.2 (1978), require that the treatment of notes for tax purposes be adjusted for unstated interest when the rate assigned is less than four percent. Because the interest rate of the note in question is four percent, no adjustment is required; nor do we believe one is necessary. We hold that both calculations should be made at face value. See *Commissioner of Internal Revenue v. Danielson*, 378 F. 2d 771 (3d Cir. 1967).

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.
Solicitor General

JUNE 1979

DOJ-1979-06